Europe
Eurozone
United States

Rates
Gov. Bonds & Swaps
Inflation
Rates Volatility

Special Report

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Bigly rates repricing

- Trump's economic plan cements the shift in the policy mix. It implies (1) increased fiscal spending, (2) reduced regulation, (3) a change of Fed leadership and (4) increased protectionism. Each one of these factors is bearish rates
- Increased geopolitical uncertainty remains a risk, but is unlikely to dominate for now
- The repricing of rates is moving from breakevens to the term premium and finally to the money market curve
- We maintain a bear steepening bias

Bigly rates repricing

Trump's victory cements the shift in the policy mix

Trump's victory is fundamentally bearish fixed income from a pure economics perspective. The key risk to the view comes from increased geopolitical uncertainty.

If Trump's economic program is taken at face value, it would imply (1) increased fiscal spending, (2) reduced regulation, (3) a change of Fed leadership and (4) increased protectionism. Each one of these factors is bearish rates.

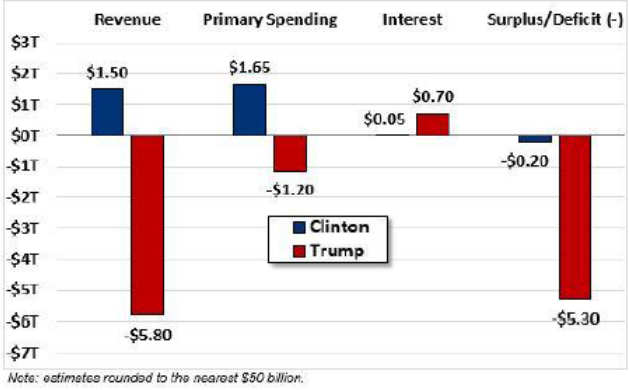
First, as we highlighted last week, Trump's plan is consistent with more than 2.5% of GDP of annual fiscal stimulus over the next ten years (see table below). Of course, the extent to which the plan will be implemented is unclear. However, Trump is arguably in a strong position relative to the Republican Party and the latter controls both the House and the Senate. This should give Trump leverage to implement his fiscal plan, at least initially. Also, one of the clear statements made by Trump in his acceptance speech was that he intends to significantly increase infrastructure spending. It is worth noting that the Fed in principle welcomes more fiscal support as it sees the US economy as being constrained by a lack of demand. Given that the fiscal stimulus will occur as the US economy is close to full employment, it should have a faster spillover on monetary policy, notwithstanding the desire from the current Fed leadership to run the economy hot. Increased fiscal spending should be supportive of higher yields from a macro perspective (supports domestic demand and inflation) and from a flow perspective (reduces the supply/demand imbalance).

Estimate fiscal impact of Trump's proposals

Estimated 10Y fiscal impact of candidates' proposals (USD, negative adds to debt)	
Proposal	**Trump**
Health policies	-0.05 trn
Tax policies	-4.5 trn
Spending policies	0 trn
Immigration policies	-0.05 trn
Subtotal, Proposals	-4.6 trn
Net interest	-0.7 trn
Total Budgetary Impact	-5.3 trn

Source: Deutsche Bank, CRFB

Trump's fiscal plans are considerably more expansionary



Source: Deutsche Bank, CRFB

Second, Trump has expressed the desire to "get rid of Dodd-Frank" and more generally expressed the need to relax excessively tight regulation. Easier regulation would also be supportive of higher rates from both a macro perspective (higher credit multiplier) and flow perspective (less regulatory driven demand for safe assets).

Third, Trump has stated his intention to change the Fed's leadership. Yellen's current term ends early 2018. At the moment, she appears unlikely to resign. It is also unclear who would be her successor. The thinking is that the new leadership would be less dovish, although that could change over time. While the repricing of monetary policy may be latest driver of higher rates to take hold, the risks are tilted towards a less dovish Fed beyond 2017.

As previously argued, the combination of tighter fiscal policy, tighter regulation and aggressive monetary policy in DMs was the perfect recipe for a depressed term premium and low core rates. The market has been underpricing the potential for a change in the policy mix given that: (a) further monetary policy easing has reduced marginal benefits, (b) the fiscal multiplier is likely to be high in the context of low real yields and relatively constrained credit conditions, (c) the political environment and (d) most of the key new regulations have been implemented. A Trump presidency significantly increases the likelihood of a rebalancing of the policy mix. This would represent a structural change from the post crisis norm and should result in higher term premia.

Finally, the move towards more protectionism is akin to a negative supply shock which increases trade barriers. This should lead to higher inflation and lower growth. Such a combination is on balance bearish for bonds as the negative correlation between inflation and growth would not justify their current negative risk premium.

The key risk to this view would come from increased geopolitical uncertainty that could be triggered amongst others by an aggressive approach to trade negotiations. This risk is difficult to assess. However, following Trump's acceptance speech, it seems less relevant for now than the other four factors mentioned above.

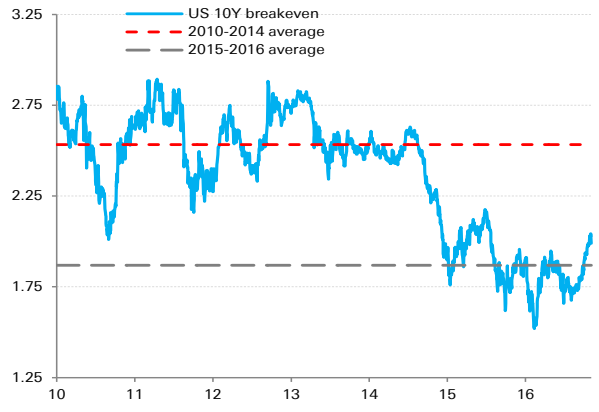
What are the market implications? Let's start with our ex-ante assessment published last week. "A Trump victory would increase short-term uncertainty, but should lead to higher deficit expectations. This could delay the Fed, but should put more pressure on the long-end of the curve. However, given that the Fed pricing is already benign and that Trump is likely to seek to appoint a more hawkish FOMC chair, it is not clear that the front-end has much scope to rally beyond the first couple of contracts. In fact, any rates rally following a

Trump victory should be an opportunity to increase the bearish rates bias." This assessment remains valid. If anything the repricing towards higher rates has occurred faster than anticipated.

More generally, the normalization of interest rates can be seen as a three step process: first, a widening of breakevens which is a pre-condition for a shift in monetary policy; second, a normalization of the term premium that would signal the need to normalize policy rates; third, a repricing of Fed expectations.

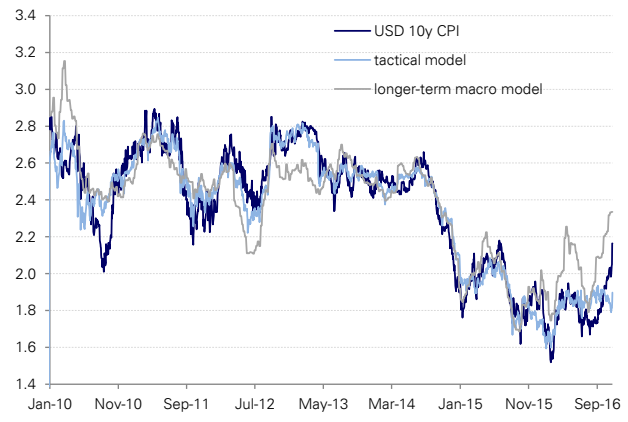
The first step is well advanced. Breakevens have increased by 40bp since the summer and are now half way between the recent lows and their pre-crisis average. Breakevens have also partially converged towards their medium-term underlying macro drivers. Breakevens are even ahead of shorter-term tactical indicators (see graph below).

Breakevens remain below the 2010-2014 average



Source: Deutsche Bank, Bloomberg Finance LP

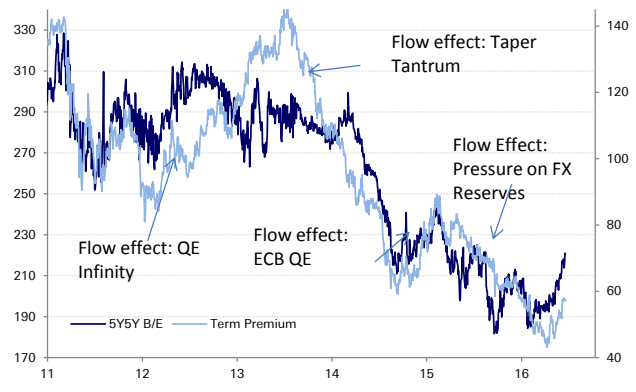
US breakevens are ahead of shorter-term tactical market models but have not bridged the gap relative to long-term macro models



Source: Deutsche Bank, Bloomberg Finance LP

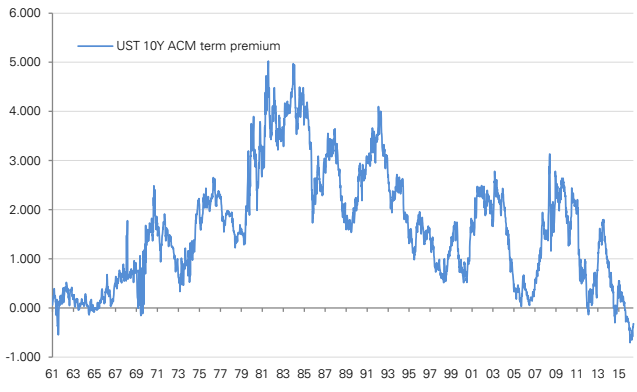
Second, the term premium, has increased recently, but is lagging the repricing of breakevens (see the graph below). In fact, with the exception of the last few months, the term premium remains at historical lows (see graph below).

The term premium continues to lag the repricing of inflation



Source: Deutsche Bank, Bloomberg Finance LP

With the exception of the last few months the term premium remains at historical lows



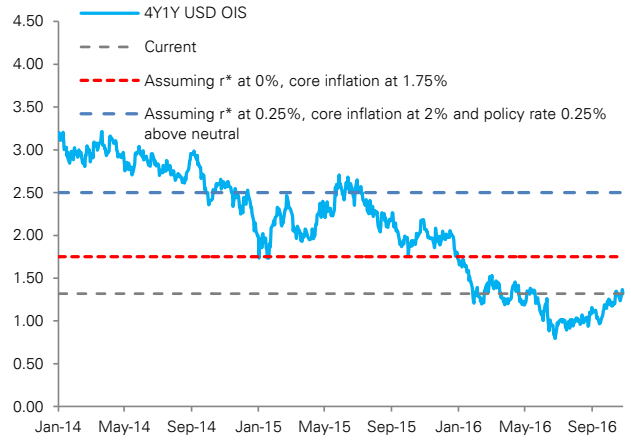
Source: Deutsche Bank, Bloomberg Finance LP

Finally, Fed expectations remain very benign with just about one hike priced per year. Even if one assumes that the neutral real rate stays at zero and core

inflation stays at 1.75%, the policy rate at the end of the tightening cycle should at least reach the neutral nominal level of 1.75%. The market is still not pricing this outcome as the 4y1y OIS remains below 1.5%. Moreover, the shift in fiscal and regulatory policies creates upside risks to both the neutral real rate and core inflation. Also, at the end of the cycle the Fed should arguably be above the neutral rate. Therefore, even with conservative assumptions of the neutral real rate increasing to 25bp, core inflation returning to target at 2% and the policy rate being above neutral by 25bp, 4y1y should reach 2.5%.

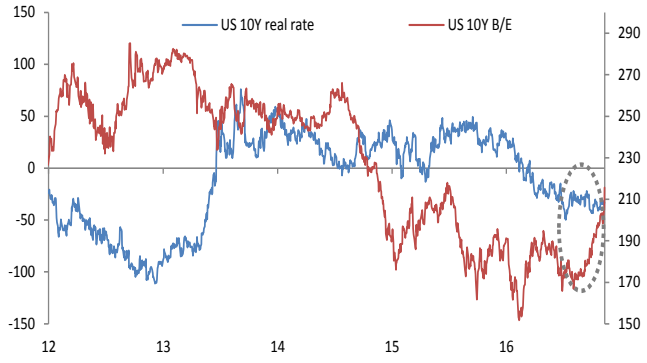
Finally, the repricing so far remains more about breakevens than real rates in the US (see graph below). As a result, financial conditions remain easy, which should support growth.

Market pricing of the neutral nominal rate remains depressed



Source: Deutsche Bank, Bloomberg Finance LP

The US repricing remains more about breakevens than real rates

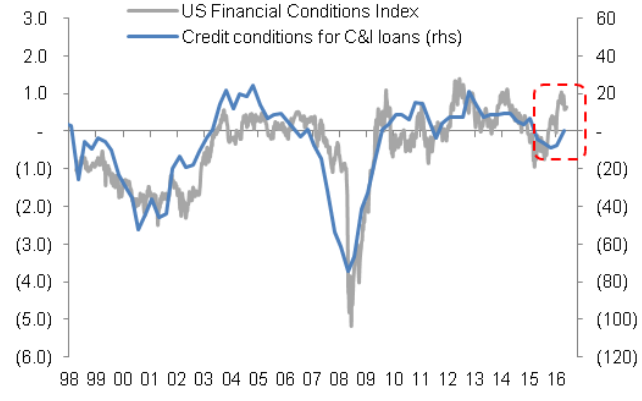


Source: Deutsche Bank, Bloomberg Finance LP

Data also supportive of higher rates

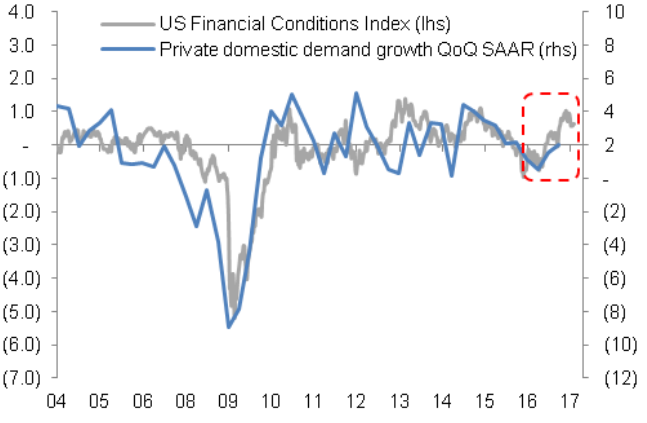
The data released this week was also generally supportive of higher rates. First, the loan officer survey showed some mild improvements which are supportive of better growth momentum into Q4 (see graphs below).

Financial conditions remain accommodative relative to history



Source: Deutsche Bank, Fed SLOS, Bloomberg Finance LP

Financial conditions would be consistent with an improvement in domestic demand growth

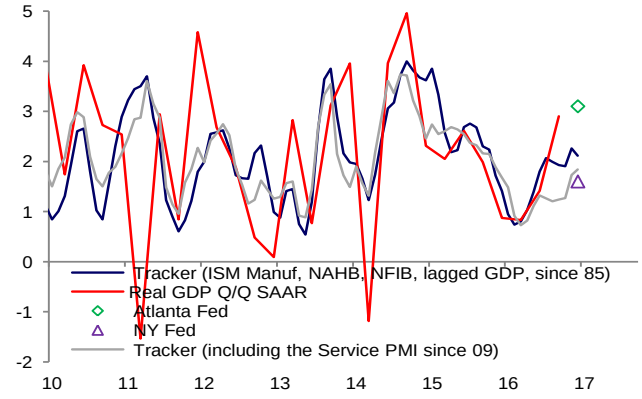


Source: Deutsche Bank, Fed SLOS, Bloomberg Finance LP

The lending survey is confirmed by generally improving business surveys which suggest a pick-up in underlying trend growth in Q4. On the wage front, leading indicators of wage inflation continue to point to wage inflation in a 2.6-

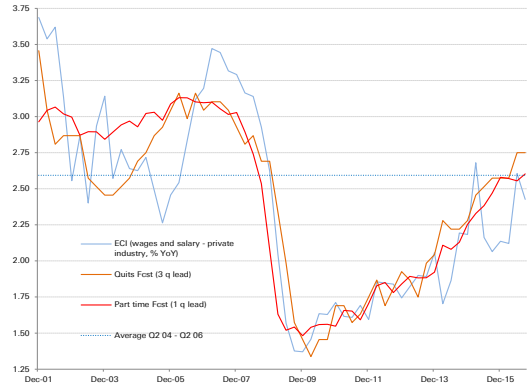
2.8% range.

Business surveys suggest a pickup in underlying trend growth in Q4



Source: Deutsche Bank, Haver Analytics

Leading indicators of wage inflation point to wage growth in a 2.6-2.8% range



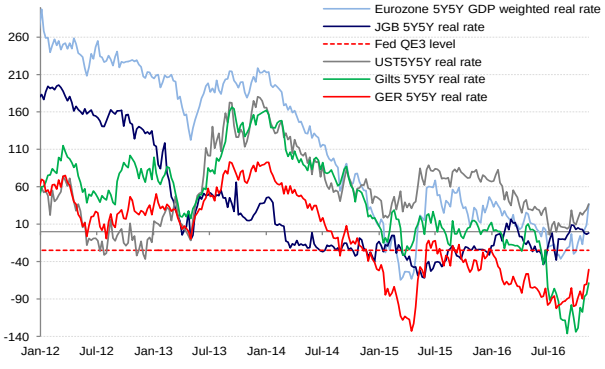
Source: Deutsche Bank, Haver Analytics

Trades recommendations: Maintaining a bear steepening bias

We maintained last week our bearish rates bias despite the risk posed by the US election. Market pricing was benign relative to either a Clinton (front-end sell off) or Trump (long-end sell off) scenario. As discussed above, there is no reason to change this view. We thus maintain the strategic term premium trade in the US (5s10s steepener with a 17% short in 2s) and the short Dec-17 eurodollar to reflect the potential repricing of monetary policy. We also maintain the long JPY 2Y as a hedge against risk off.

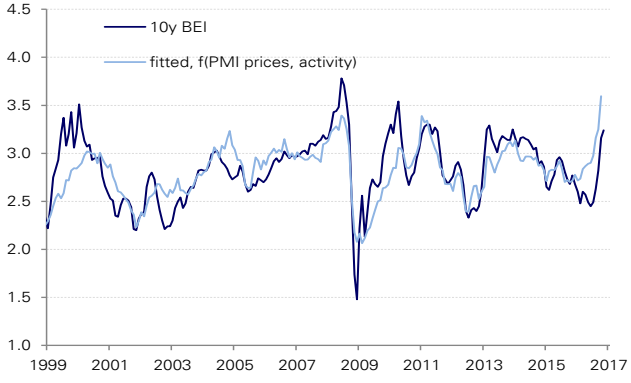
In the UK, we maintain our short 10Y real rate. This is a strategic trade motivated by the fact that UK real rates remain the most expensive cross market. We hedge the short GBP10Y B/E with a long USD10Y B/E. The trade was meant to tactically capture the richness of breakevens relative to short-term market models and was also supported by the change in the BoE's stance. However, the outlook has turned more positive for breakevens globally fundamentals remain supportive of a general increase in inflation expectations as explained above (see also chart below for the UK). We also exit the UKT 10s30s steepener which is close to target following the recent re-steepening from the end of October lows.

UK real rates remain rich on a cross market basis esp. vs. EUR real rates



Source: Deutsche Bank, Bloomberg Finance LP

Fundamentals remains supportive for UK breakevens



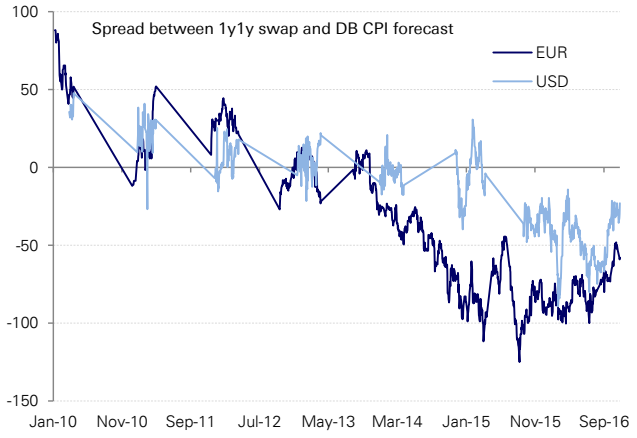
Source: Deutsche Bank, Bloomberg Finance LP, Haver Analytics

Finally, Europe should reflect the global steepening trend, but less strongly

than elsewhere for the following reasons. First, the sell-off has comparatively been more driven by real rates than in the US or the UK (see graph above for the GDP weighted 5y5y real rate), while estimates for the neutral real rates are lower than in the US and much lower than in the UK. Second, the scope for more aggressive fiscal easing is more limited. Third, political risk has the potential to become significantly more systemic.

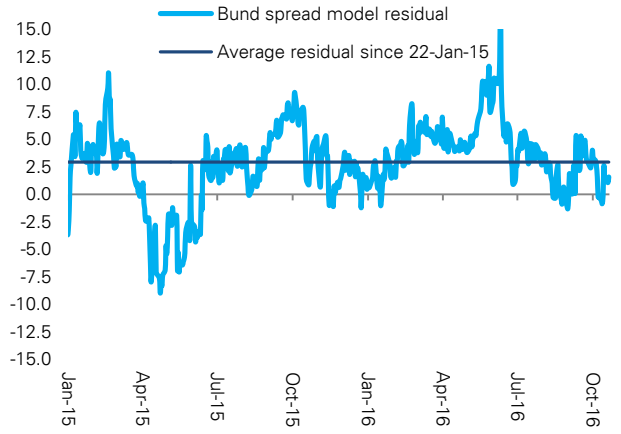
In order to reflect these relative risks, we make the following adjustments to the portfolio. First, we rotate the Germany 10s30s steepener into a long Bund short 30Y France to capture an increased risk premium in France. Second, we move the long breakeven from 10Y to 5Y (to reduce some of the EUR steepening bias). Fundamentally, the EUR breakeven market remains the cheapest vs. forecasts (see graph below). Third, to reflect the relative pressures on US and EUR rates and their relative breakeven performance, we go long EUR 10Y real rates vs. USD. Fourth, we rotate the Italy 10s30s flattener into a short 10Y BTP. Finally, we add a long Bund ASW which appears relatively cheap (see graph below) and is a hedge against an increase in risk aversion.

EUR breakevens remain cheap relative to forecasts



Source: Deutsche Bank, Bloomberg Finance LP

Bund ASW is not too rich relative to the post ECB QE average dislocation



Source: Deutsche Bank, Bloomberg Finance LP

Appendix 1

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