NATIXIS INVESTMENT MANAGERS | SOLUTIONS

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PORTFOLIO ANALYSIS & CONSULTING

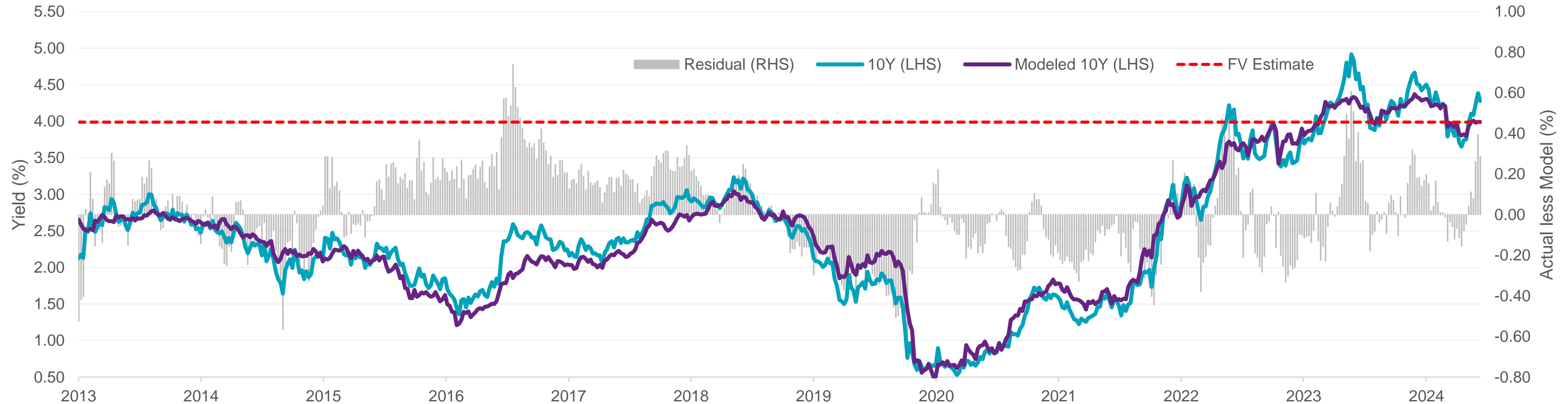
Charts and Smarts®

Jack Janasiewicz, CFA® – Portfolio Manager and Portfolio Strategist

Garrett Melson, CFA® – Portfolio Strategist

Flight of Icarus

10Y Yield vs Fair Value Estimate (5/31/13–11/8/24)

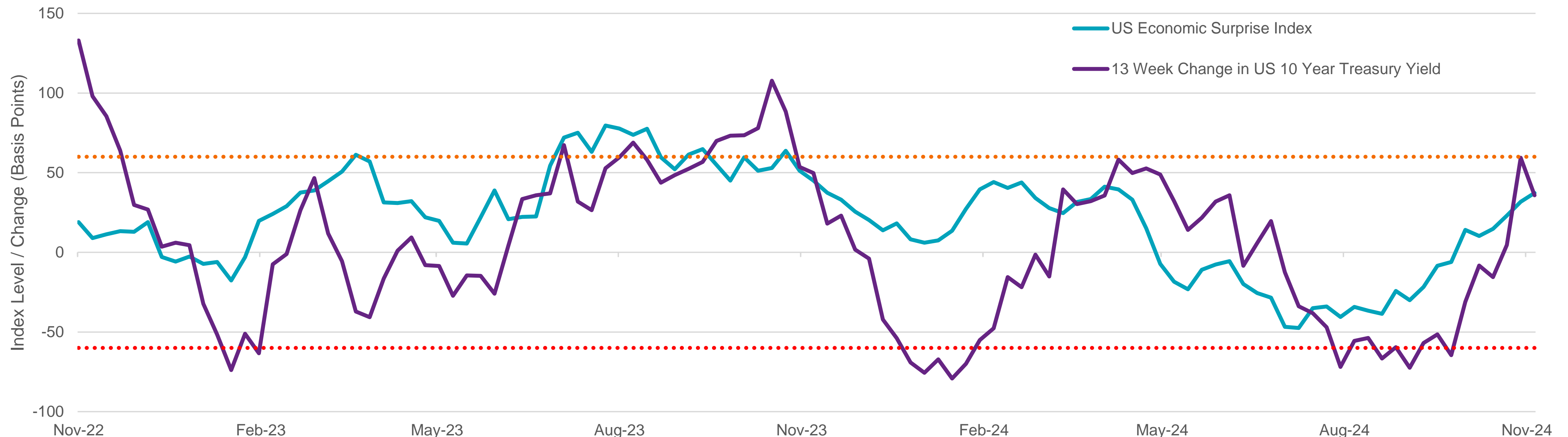


Here we go again. Once again, we've come all the way back from the abyss with recession fears running rampant to pricing in a structurally higher nominal growth environment and a higher neutral rate. We just can't help ourselves. Narrative overshoots are ever present in financial markets, but they've become a defining feature of the past few years, particularly in the rates market. Time to dust off that fair value model of the 10-year Treasury Yield as we witness the third no-landing overshoot in just the past three years. You'd think by now we'd know better than to continue extrapolating individual data points, but that's just the nature of the market's overreaction function. And just like last year's overshoot to 5%, the narrative, which started as a fundamental repricing of the growth outlook, has broken down into a technically driven buyers' strike, being fueled by deficit fears with a sprinkle of the Trump trade mixed in. But as we've stressed repeatedly, overshoots of this magnitude tend to be short lived and have a habit of reverting sharply. Given the results of the election and expected policy agenda under the Trump administration of deficits, deregulation, and tax cuts, we may have seen a shift higher in the trading range of the 10-year yield. While our fair value model remains pinned to 4%, we would expect to see growth revisions help push that estimate modestly higher over the coming weeks. But to the extent that the recent overshoot was partially a front running of the Trump trade, we witnessed in the wake of the 2016 election, rates appear to have done much of the heavy lifting to price in that stronger-than-expected growth outlook. The bias to rates from here looks to be sideways to modestly lower, similar to the 2016 experience. And that means the overshoot may very well resolve through a combination of fair value drifting higher, as rates modestly rally from a technical overshoot as rate volatility stabilizes at a higher level.

Source: Portfolio Analysis & Consulting, Bloomberg. Model consists of 5Y5Y Forward Breakeven, JPMorgan US Forecast Revisions Index, 3m3m OIS, Percent of Global Debt with Negative Yield, and net 10Y Noncommercial futures positioning.

Run to the Hills

US Economic Surprise Index vs US 10 Year Treasury (11/4/22–11/1/24)



While the market's repricing of Trump's odds to win the election was certainly a factor in the sharp selloff in rates over the past six weeks, our sense is that many market participants placed too much of that widening on the Trump Trade itself. From our perch, initial conditions and stronger economic data drove the majority of that repricing. The combination of stronger economic data, namely firmer labor market data, robust retail sales, and modestly warmer inflation prints, combined with the Fed's explicit defense of the labor side of the mandate, demonstrated by the 50-basis point cut to kick off the easing cycle, meaningfully clipped downside left tail risks. The result was a sharp unwind of recession hedges, seen both in the rates market as yields pushed higher as well as in equities as cyclicals reclaimed leadership over defensives. Nominal yields tend to track nominal growth over time, and as a result, the changes in the 10-year Yield tend to track closely with changes in the economic surprise index. As the data firms, yields tend to rise, and the past six weeks were no exception as data has both improved and steadily outperformed expectations. To the extent that the data itself was the key driver of the backup in yields, there's scope for a reversal from these levels as expectations have caught up with reality, just as modest growth headwinds have increased over the next few months. While the lower end of the trading range for the 10-Year may now be higher, there's scope for a modest rally in rates from current levels.

Source: Portfolio Analysis & Consulting, Bloomberg.

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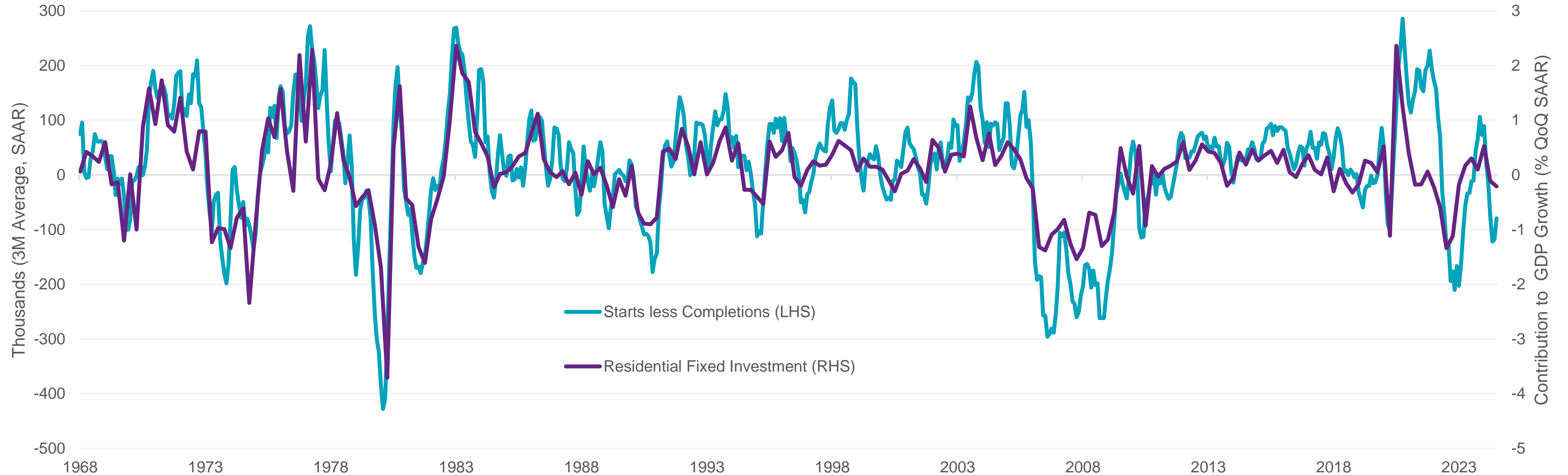
Purgatory

Single Family Starts & Completions vs Residential Fixed Investment (1/31/68–9/30/24)



Growth has indeed remained remarkably resilient in the face of persistent skepticism and recession fears. But the latest no-landing overshoot driven by just that resilience is likely to serve as something of a governor on the pace of growth in the coming quarters. With the latest selloff in rates, 30-year fixed mortgage rates have backed up over 7% once again, putting the housing market back into stasis after showing little signs of warming, despite the rally in rates over the summer months. While homebuilders continue to have levers to pull to entice buyers through rate buydowns and other concessions, housing activity has remained soft. As a result, completions have been meaningfully outpacing starts on new units, placing downward pressure on the number of units under construction. Remember, it's construction activity that feeds into residential fixed investment when it comes to GDP bean counting, and with units under construction falling, residential investment is likely to weigh on GDP growth again for Q4. The economy has been able to source growth from other sectors while the housing market has remained stagnant, and the drag on growth is likely to be sequentially larger in the current quarter. Housing continues to be a story of growth that is delayed rather than destroyed, but to the extent the repricing in rates has been a function of repricing the growth outlook, weakness in housing provides scope to expect some retracement in rates in the months ahead.

Source: Portfolio Analysis & Consulting, Bloomberg.

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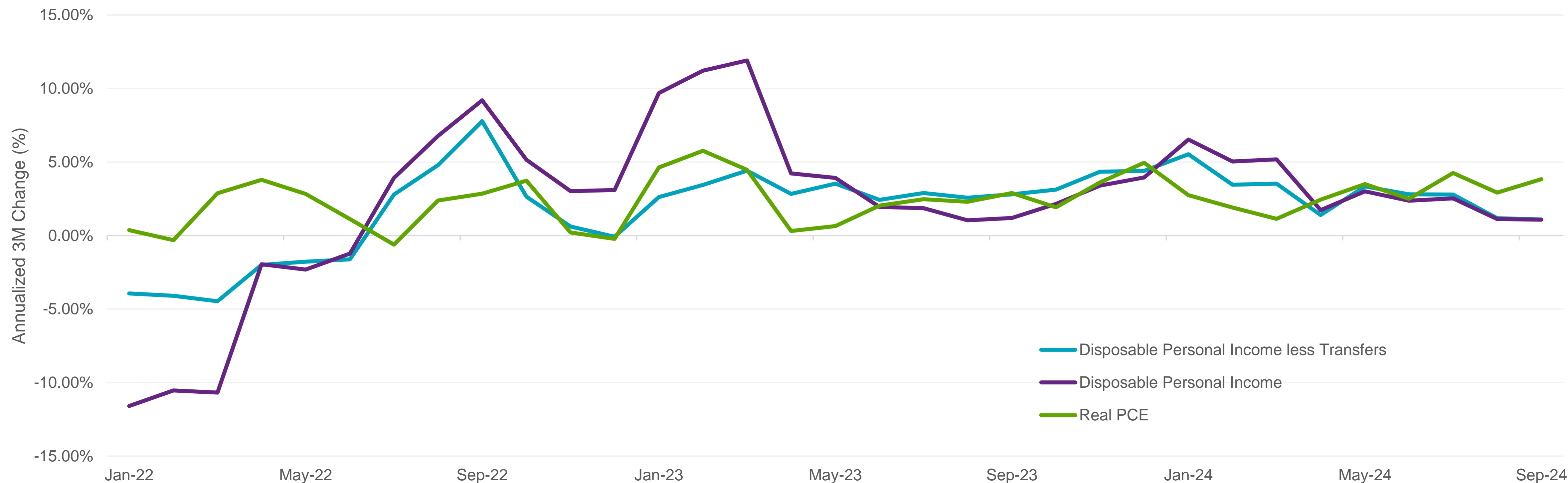
The Prisoner

Real Personal Income vs Personal Spending (1/31/22–9/30/24)

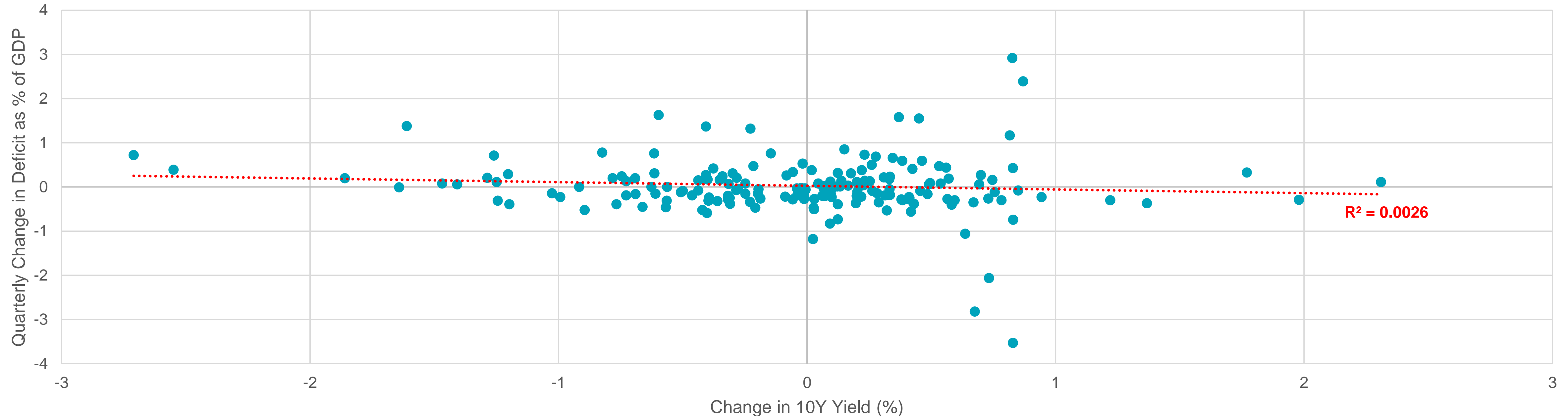


Another reason to expect sequentially softer growth, just as the narrative has overshot, is the potential for softer consumer spending in the coming months. We'll be the first to remind our readers never to bet against the US consumer, but there's reason to expect marginally cooler consumption at least in the near term. This has indeed been an income-driven cycle with organic income growth, not credit growth, fueling consumption. The national account revisions we highlighted last month suggest a healthy buffer of savings to support consumer spending, however, in the near term, there are downside risks for consumption as real spending growth has outpaced real income growth as wages have continued to soften, and recent inflation prints have been modestly warmer. We are by no means betting against the consumer, but given the shift in the market narrative, softer consumption in the coming months is simply another reason to fade the repricing in the rates market as the heart of the US economy, consumption, sequentially cools off at the margin. But don't expect that to last. We've seen this song and dance before as wages tend to track with consumption over time, with periods of excess consumption over income growth giving way to a period of excess saving. We're simply looking at one of those periods of ebbing consumption growth in the near term, which may very well help pull the narrative and rates markets back from overshoot territory.

Source: Portfolio Analysis & Consulting, Bloomberg.

The Number of the Beast

Change in Deficit vs Change in 10Y Yield (6/30/80–9/30/24)



While we're on the topic of rates, let's address the elephant in the room: deficits. Deficits and bond vigilantes have become bubble talk of the rates markets. If equities are up a lot, it's a bubble. If rates are up a lot, it's the deficit and bond vigilantes imposing their will. Economic theory would suggest that higher deficits equate to higher rates, but all the economic theory in the world can't change the fact that changes in the deficit have historically had no meaningful relationship with changes in yields. Since 1980, changes in the deficit have had almost no relationship with changes in the 10-Year yield. Of course, deficit fears can become embedded in the market narrative and lead to upward pressure on rates as we saw just one year ago. But last we checked, it wasn't the announcement of austerity measures that drove the 10-Year yield from 5% to 3.8% over the span of two months to end 2023. For all the concerns about the Trump administration continuing to run up massive deficits, deficits don't inherently translate to upward pressure on yields. And that's particularly true for the US. US exceptionalism isn't just about stronger growth. It's about stronger equity markets, stronger demographics, a stronger military, more advanced technology, and a more resilient political system, just to name a few. All of these add to investor confidence, thereby supporting investor demand and keeping funding costs in check, despite rising debt. We're in a period of secular US exceptionalism, which political views aside, a Trump administration is likely to further bolster. Could this privilege fade? Of course, but that's a process that is likely to be long and drawn out. In the interim, fade the deficit fears. Growth and inflation expectations matter more.

Source: Portfolio Analysis & Consulting, Bloomberg.

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