Overweight US Long Treasuries vs US Treasuries

Recommended Since September 30, 2023

INVESTMENT THESIS: We expect US Long Treasuries to outperform US Treasuries over a one- to three-year period given they appear both oversold and cheap. In addition, the macro-economic and policy backdrop should become more supportive during 2024 if economic activity slows, inflation declines further, and the Fed delivers on rate cuts as we expect.

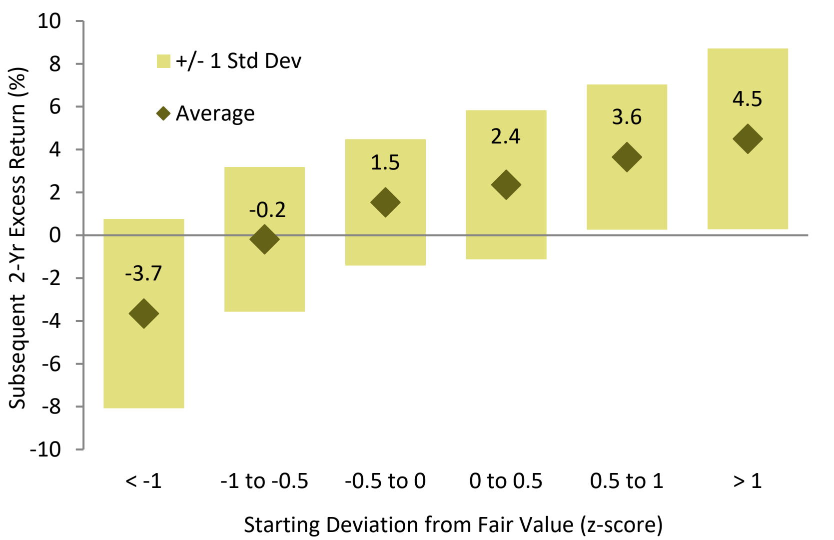
- **KEY SUPPORT #1:** The sharp rise in interest rates has resulted in one of the worst bond bear markets on record, with US Long Treasuries declining as much as 40% over the previous three years. However, the sell-off appears to have bottomed with Treasury yields likely peaking in 4Q 2023 due to softer inflation and the signal from the Fed that it expects to begin cutting rates this year. US Long Treasuries tend to outperform heading into and following the first Fed rate cut, suggesting this trade has more upside if/when the Fed begins cutting rates.

- **KEY SUPPORT #2:** US Long Treasury valuations became extremely cheap in 4Q 2023. Ten-year Treasury yields peaked at 5%, more than 1 standard deviation above their estimated fair value of 3.9%. While valuations have normalized somewhat, they still favor US Long Treasuries based on current levels (ten-year Treasuries are yielding 4.2% as of March 31, which is 0.3 standard deviations above fair value) and considering their starting point (cheap). We would look to close this trade if valuations fell below their fair value, all else equal.

- **KEY RISKS:** The major concern for this trade is resilient US growth pushes up inflation and forces the Fed to keep rates elevated for longer than anticipated. Challenging supply and demand technicals could also increase volatility in a bearish scenario for fixed income. Non-US investors should consider the impact of FX volatility and regional differences in macro and policy outcomes.

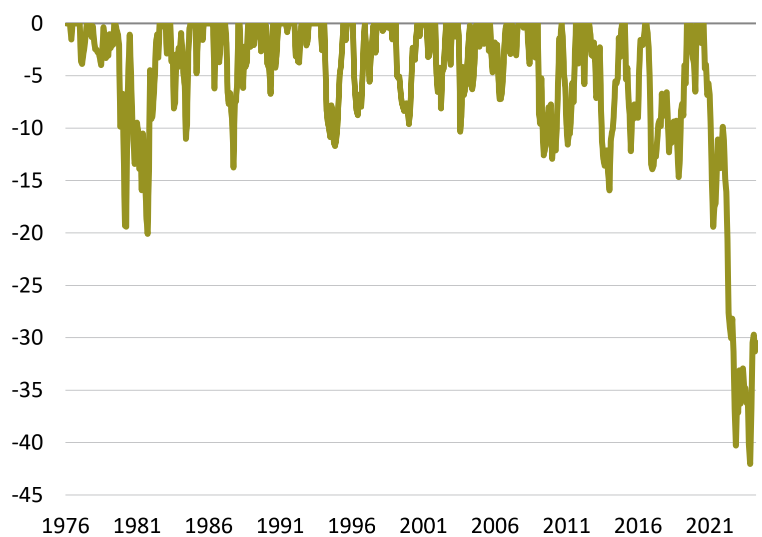
US LONG TREASURIES VS TREASURIES: VALUATIONS & PERFORMANCE

January 31, 1973 – March 31, 2024 • Average Annual Compound Return



US LONG TREASURIES: ROLLING 3-YR MAX DRAWDOWN

January 31, 1973 – March 31, 2024 • Total Return (%)



Sources: Bloomberg Index Services Limited, Federal Reserve, Thomson Reuters Datastream, US Department of Commerce - Bureau of Economic Analysis, and US Department of Labor - Bureau of Labor Statistics.

Notes: The starting deviation from fair value is the deviation of ten-year US Treasury yields from their fair value shown as a z-score. Fair value is estimated using a multiple linear regression model that includes trailing ten-year real GDP and headline CPI growth. GDP data are as of December 31, 2023, and CPI data are as of February 29, 2024.