2018 GLOBAL RATES OUTLOOK: U.S. TAXES TRUMP GOLDILOCKS

“Rarely has the long-term rate outlook been more dependent on the short term.”

– Shyam Rajan, head of U.S. Rates Strategy

“Investors have been ignoring U.S. tax reform and its implications at their own peril. Tax cuts would lead to higher U.S. rates and a higher U.S. dollar in 2018, at least in the first quarter, and we don’t believe the markets are prepared for simultaneous upward pressure on rates in the U.S. and Europe.”

– David Woo, head of Global Rates, FX and EM Fixed Income Strategy & Economics

Our view

US and them: We are more bullish than consensus on the probability that the U.S. Congress will pass tax reform and the impact it is likely to have on the rates markets. U.S. tax reform is moving toward the finish line, and our core views are based on an expectation of higher rates and steeper curves, fading the end of cycle risks priced into the rates market next year. Tax reform could be a trigger for higher intermediate rates. If Congress were to fail, the outlook for the rate hiking path by the Fed is likely to quickly fade and market pricing for the Fed in 2018 may not be realized.

Controlled adjustment in Fed hikes: We are long U.S. rate volatility, as the market seems to be more sensitive than usual to inflation data. If the Fed convinces the market of its ability to deliver a rate path consistent with the dots, five-year rates could trade above 2.5 percent, while volatility may not rise significantly. As a precaution, we are long U.S. rate volatility and recommend owning it in the shape of the yield curve.

Impact of tax reform on long-term rates: Corporate tax reform coupled with deregulation raises the risk of higher neutral rates, or the rate at which GDP is growing and inflation remains stable. A rally in the dollar from repatriation flow could significantly lower foreign buying of U.S. Treasuries, a critical factor that has prevented yields from rising. Based on our estimates, tax reform alone could be worth 60 to 100 basis points on long-term real rates over the coming years were it to deliver a 1 percent deterioration in the U.S. forward deficit, a 1 percent decline in foreign buying as a percentage of GDP, and a 0.25 percent increase to long-term growth.

Higher U.S. Treasury yields: We believe there is political incentive to front load corporate tax cuts and, if this occurs, the U.S. deficit and net issuance of U.S. Treasuries would likely swell in 2018. This, coupled with balance sheet unwinding, could mean a spike in net supply of Treasuries the market would have to absorb. As a result, we believe 10-year Treasury yields will make a significant move higher to 2.85 percent in the first quarter and drift higher toward 3.0 percent by the end of 2018.

Central bank reshuffle: The appearance of leadership continuity muted initial market reaction to the appointment of a new Federal Reserve chairman; however, the overall board composition is still undergoing unprecedented changes, which could lead to a more hawkish combination of voters charged with making sure the U.S. economy gets neither “too hot” nor “too cold.” Uncertainty around Fed
communication coupled with greater market sensitivity to inflation data further support the argument for being long U.S. rates volatility.

**Tapering and the year of bond surplus:** If 2017 goes down as a year of bond shortage, 2018 may be remembered for bond surplus. The ECB plans to halve its pace of asset purchases starting in January, which we believe investors have yet to fully price. Add to this the risk that the Bank of Japan reduces its purchase of Japanese government bonds and increases its 10-year yield target as well. Rates and FX volatility present value for investors.

**U.K. and U.S. divergence:** Monetary policy expectations in the U.S. and U.K. are already showing signs for continued gradual policy normalization by the Fed and a slower pace of tightening in the U.K. The market is currently pricing one more hike by the Bank of England in 2018, but the expected reduction in inflation pressure and Brexit negotiation risks make us skeptical of this. We expect wider monetary policy divergence between the U.S. and UK in 2018 and recommend positioning for this with 1y1y swap wideners.

**Key calls**

- Central bank policy rates (end of 2018): U.S. 2.1; U.K. 0.7; Euro 0.0; China 4.35; Japan -0.10
- 10-year rates (end of 2018): U.S. 2.9 percent; Bunds 0.75 percent; Japan 0.20 percent
- Best directional trade: 2–10 U.S. curve steepener (or the spread between the two-year and 10-year yield curve). Higher deficits and a fiscal boost should increase term premiums and steepen the U.S. curve.

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**10y equivalent Treasury supply to the private market (\$bn)**

![Graph showing Treasury supply to the private market from 2011 to 2018.](source: BofA Merrill Lynch Global Research)