

2022 OUTLOOK NAVIGATING UNCERTAINTY

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SOCIETE GENERALE
Cross Asset Research

US RATES VIEWS

The end of 'easy'

THE BIG PICTURE

Optimism amid uncertainties

- While **omicron variant**, supply-chain disruptions, labour shortages, and **rising inflation** are grabbing the headlines, the broader outlook for the upcoming year remains positive.
- After a sharp slowdown in 3Q (following a surge in the Delta variant), growth is expected to rebound in 4Q21 and in 2022. Our economists expect **US GDP to grow by 3.4% in 2022** following strong 5.5% growth in 2021.
- The **unemployment rate** should continue to decline from the current **4.2% now 3.8%** by end-2022, as per Fed's summary of economic projections.
- Inflation should moderate to around 2.5% in 2H22. Core CPI to moderate in 2H for an average of 3.3% in 2022.

US economic forecasts for 2022

	1Q22	2Q22	3Q22	4Q22	2022	2023
Real GDP (%qoq ann)	3.4	2.7	3.2	2.8	3.4	2.8
Consumer expenditure	4.0	3.2	2.8	3.0	3.9	3.0
Government expenditure	1.6	1.9	1.8	1.3	1.3	1.6
Investment	4.7	3.9	4.0	4.0	3.4	4.2
Residential	2.5	1.8	1.8	1.8	-1.2	1.8
Non-residential	5.2	4.4	4.5	4.5	4.7	4.8
CPI Headline (% yoy)	5.5	4.0	3.0	2.5	3.7	2.5
CPI Core (% yoy)	4.7	3.3	2.6	2.5	3.3	2.5
Unemployment rate (%)	4.3	4.3	4.2	4.1	4.2	3.9

Source: SG Cross Asset Research/Economics

10Y TREASURY AT 2.25% BY END-2022

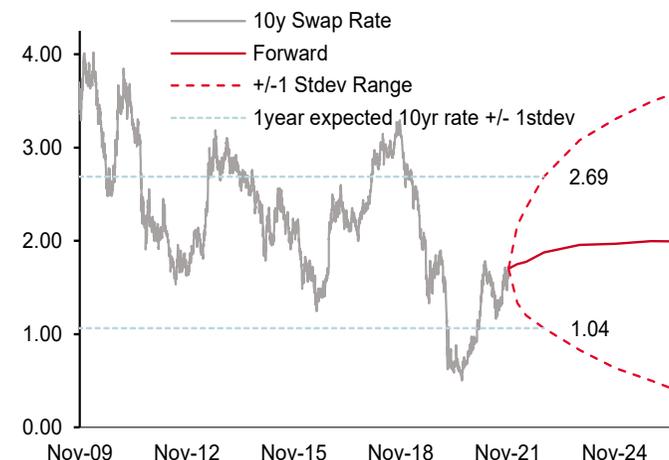
Modestly higher yields

- In this context, we expect 10yT yields to gradually rise in 2022 ending the year around 2.25%.
- Forecasting the path for monetary policy and rates is likely to be challenging. The volatility markets are pricing a wide range of outcomes for the 10y swap rate in a year's time.
- Based on the current forward curve and ATM swaption vols, the 10y swap rate could get close to 2.70% on the upside and as low as 1% a year from now.
- Payer option skew on 10y and 30y tails has remained rich, suggesting a modest bias toward higher yields.

US Treasury forecasts for 2022

Rates (%)	1Q22	2Q22	3Q22	4Q22
2y	0.60	0.75	0.85	1.00
5y	1.40	1.55	1.70	1.80
10y	1.80	1.95	2.10	2.25
30y	2.15	2.30	2.45	2.60
Curves (bp)				
2s5s	80	80	85	80
2s10s	120	120	125	125
5s10s	40	40	40	45
5s30s	75	75	75	80
10s30s	35	35	35	35

Market implied +/-1 standard deviation range for 10y rate based on forwards and swaption vol



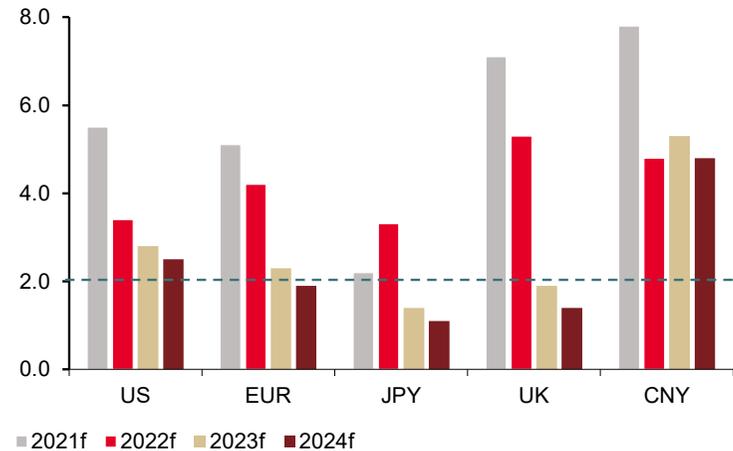
Source: SG Cross Asset Research/Rates

KEY THEMES FOR GLOBAL ECONOMIES

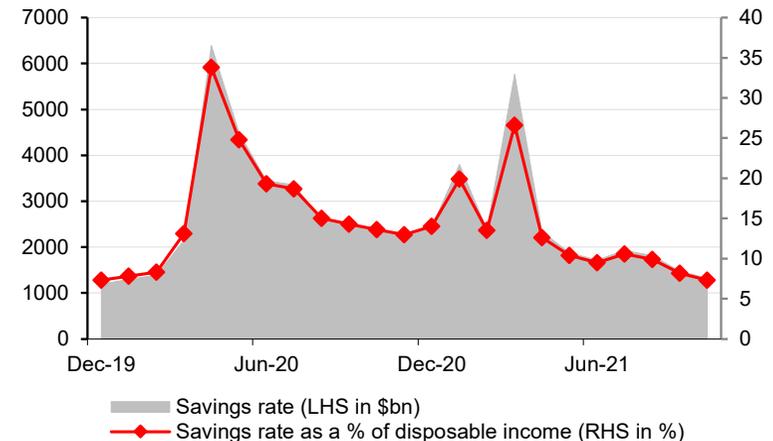
From rebound to cruising

- **Slower, but still very strong growth** - In most economies the rebound from the COVID-crisis is now largely complete in the sense that the pre-pandemic peak in GDP has been regained, though most are still a bit short of the pre-pandemic trend.
- The growth momentum is supported by lingering effects of policy stimulus, cashed-up households, prospects for solid business investment – not least for the greening of the economy.
- **Consumption-led cycle** - “excess” household savings have to date continued to grow, and our estimate of the sum of these in just the US, euro area, UK, Japan and Australia amount to USD4.1tn – that’s 5% of global GDP. Although savings rates have declined in the US effects of monetary and fiscal stimulus linger.

Growth expected to above 2% for advanced economies



Savings rate as a percentage of disposable income has normalized in the US



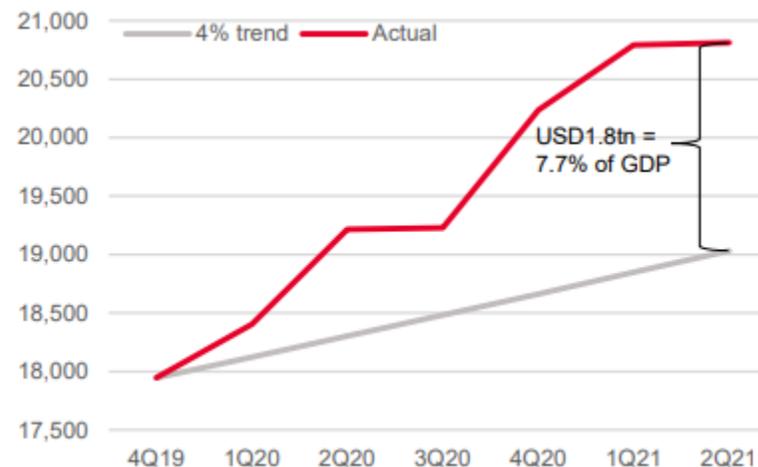
Source: SG Cross Asset Research/Rates, Bloomberg

KEY THEMES FOR GLOBAL ECONOMIES

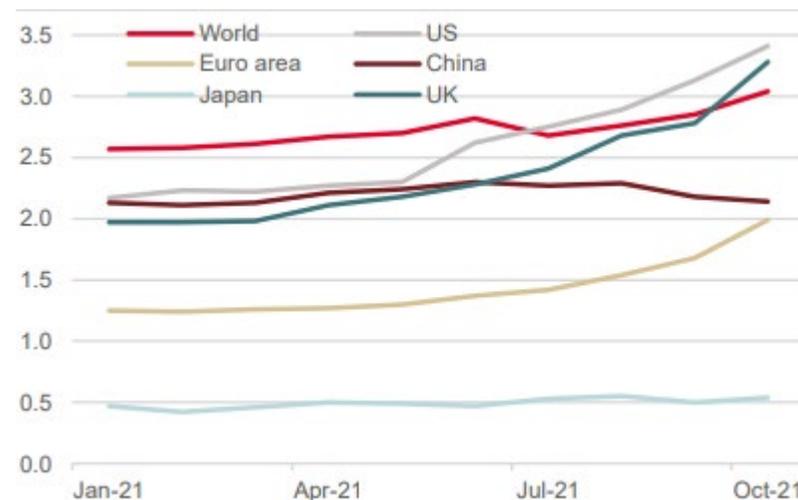
From rebound to cruising

- **Savings are in highly liquid instruments** - majority of the growth in household savings is held in highly liquid instruments, which could be spent quickly. The value of directly held stocks by households has jumped by an astonishing 45% since 4Q19, or by a mind-boggling USD9.5tn. Household balance-sheets are in much better shape than after the financial crisis.
- **Its all about inflation** - upward revisions for 2022 are to a substantial degree driven by upside surprises at the end of this year, and carryover effects are especially important in inflation, because there is usually a lot of inertia. But the fact that most recently upward revisions of 2022 CPI forecasts have been accelerating – and often outpacing those for 2021 – ought to be of some concern.

US household deposits – Checkable, time and savings, money market fund shares, debt securities (\$bn)



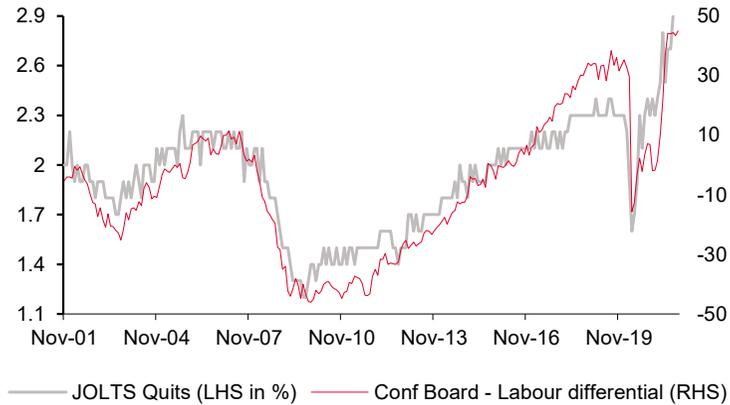
2022 CPI inflation median forecasts – Major economies



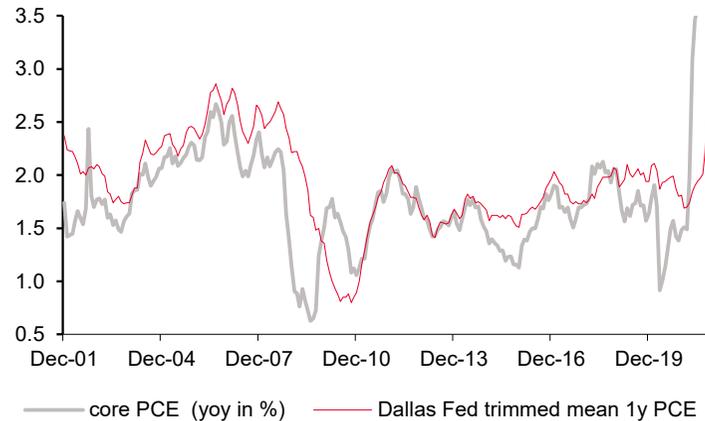
Source: SG Cross Asset Research/Economics

TRACKING INFLATION

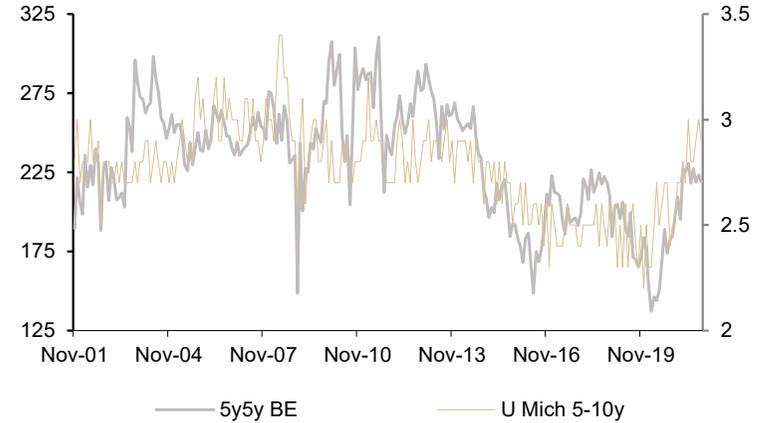
JOLTS quits rate and Conference Board labour differential show robust job market and rising risk of wage pressures



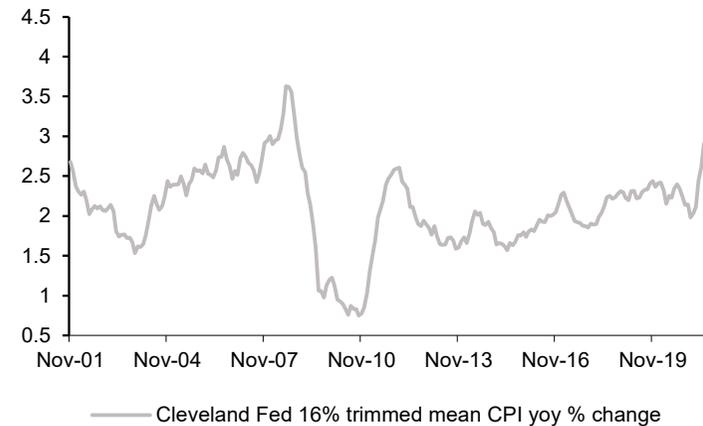
Dallas Fed Trimmed Mean PCE inflation rate starting to gradually rise



5y5y inflation breakeven lags the rise in survey-based measure of long-term inflation



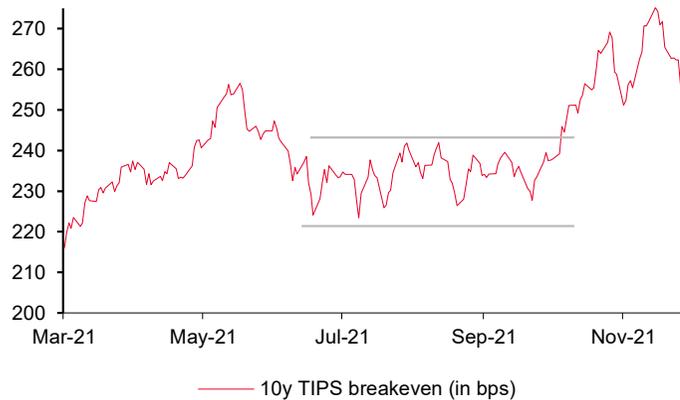
Cleveland Fed 16% trimmed mean CPI yoy % change also showing consistent gains



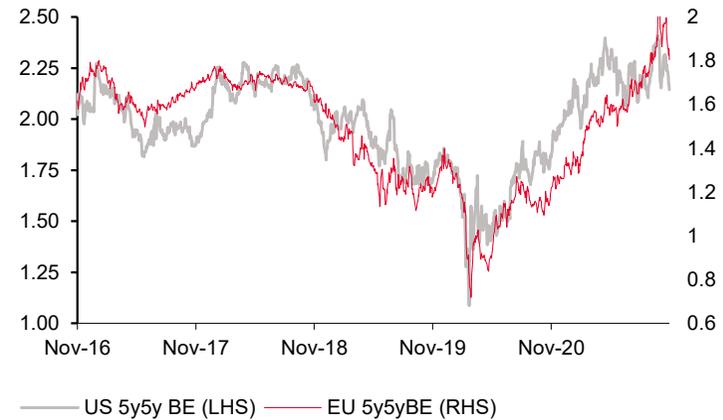
Source: SG Cross Asset Research/Rates, Bloomberg

INFLATION EXPECTATIONS HIGHER, BUT VOLATILE

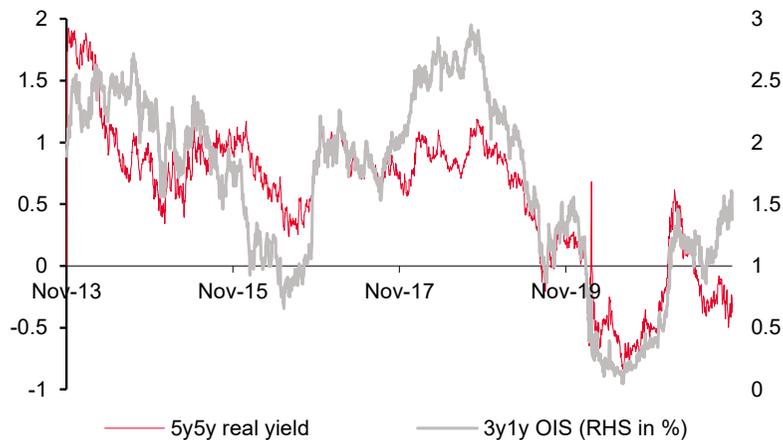
Inflation expectations decline sharply in anticipation of policy action



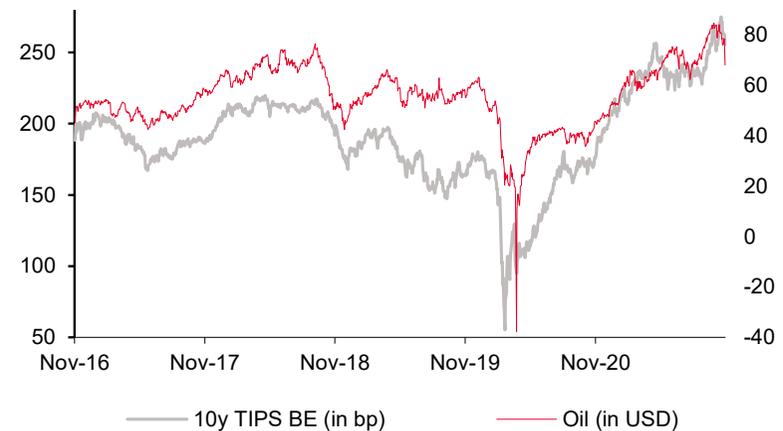
US 5y5y inflation breakeven catching-up to the rise in EUR breakevens



Real yields struggle to rise despite market pricing in more hikes



Commodities contributing to the volatility in inflation expectations



Source: SG Cross Asset Research/Rates, Bloomberg

RATES VIEWS

Modestly higher yields

- **Duration** - Strong growth, higher inflation, steady employment gains and tapering of asset purchases argue for modestly higher yields across the curve. Our forecasts argue 2y yield to fall shy of the rise in yields implied by the forwards. By contrast, we forecast higher 10yT and 30yT yields than is currently implied by the forwards.
- **Curve** - We expect curves to remain in the range of current levels (top table), but steeper relative to the forwards.
- **Risks** - We also see risks to both yields and curve skewed to the downside (bottom table). Slower recovery owing to risks associated with the pandemic, persistent inflation contributing to a slowdown in growth are likely catalysts for lower yields and flatter curves. Asynchronous global growth and covid variants like to frustrate bond bears.

Scenarios for our yield and curve forecasts

	Scenario	1Q22	2Q22	3Q22	4Q22
10y	Baseline	1.80	1.95	2.10	2.25
	Upside	2.00	2.20	2.40	2.50
	Downside	1.20	1.30	1.40	1.50
2y10y	Baseline	120	120	125	125
	Upside	140	145	155	160
	Downside	60	55	55	50
5y30y	Baseline	75	75	75	80
	Upside	100	110	120	130
	Downside	60	50	40	30

Treasuries should underperform Bunds as US recovery and monetary policy run ahead of Europe

	Scenario	1Q22	2Q22	3Q22	4Q22
10y	Baseline	1.80	1.95	2.10	2.25
	Upside	2.00	2.20	2.40	2.50
	Downside	1.20	1.30	1.40	1.50
10y Bund	Baseline	0.00	0.10	0.20	0.25
	Upside	0.00	0.10	0.20	0.35
	Downside	-0.40	-0.40	-0.40	-0.40
Spread	Baseline	180	185	190	200
	Upside	200	210	220	215
	Downside	160	170	180	190

Source: SG Cross Asset Research/Rates

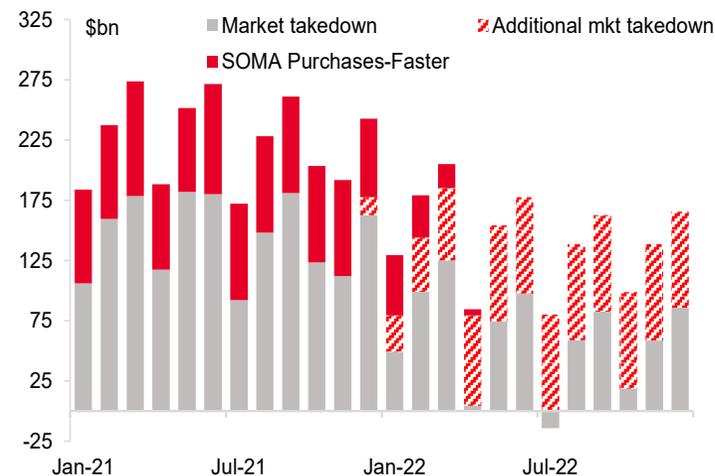
WHAT ARE THE RISKS?

Policy – hard choices

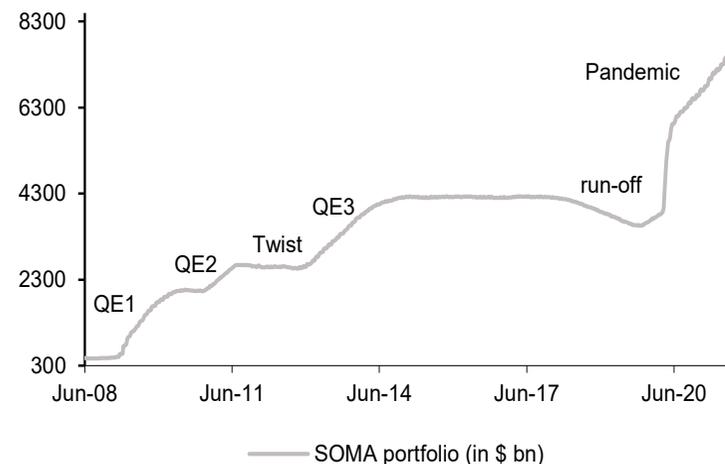
- **Faster taper** - We are in uncharted territory, with greater uncertainty around policy outcomes. A faster taper and mid-year rate hike is now our base case. In such a scenario, the Fed’s Treasury holding will increase by \$175bn (see graph) versus the previous expectation of a \$280bn increase by mid-2022 when the taper was scheduled to end.
- **Patience = policy mistake** - Larry summers - “If we let inflation accelerate, there’s almost no proven ability at the central bank to engineer a soft landing”. The Fed must weigh up those considerations against the risks of hiking too soon if inflation does decline by q2 or q3.
- **Balance-sheet run-offs** - While Fed Chair Powell has said that balance sheet normalisation is still years away, others like Bullard and Waller have mentioned shrinking

the balance sheet.

Faster taper is an under-priced risk



Evolution of the Fed’s balance sheet



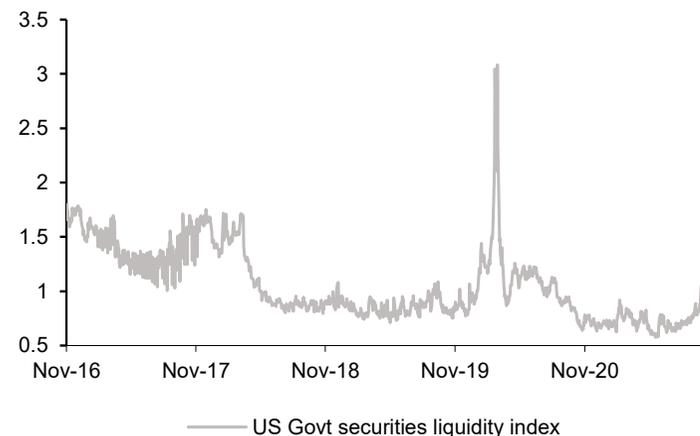
Source: SG Cross Asset Research/Rates, Bloomberg

WHAT ARE THE RISKS?

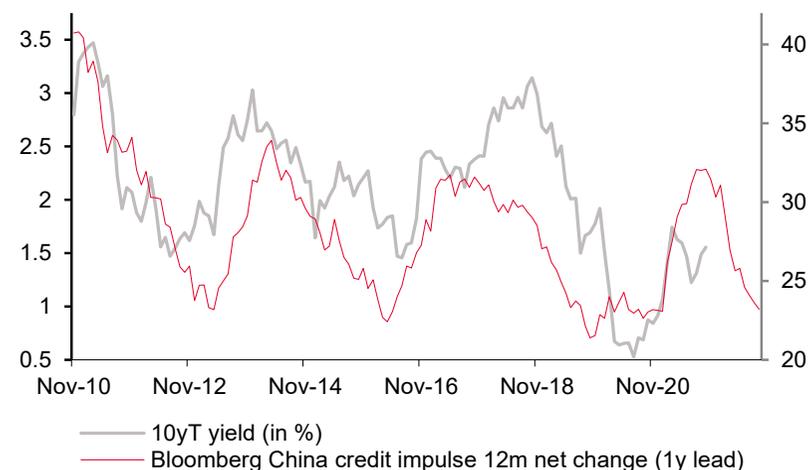
There's more!

- ***Illiquid Treasuries?***- While the Fed embarks on tapering asset purchases, liquidity conditions in Treasuries seem to be deteriorating. Unwinds of steepeners and short volatility positions (in the top left) are exacerbating intraday realised volatility and impacting liquidity conditions across the curve.
- ***China slowdown*** - China's economy is slowing rapidly. Our economists expect growth to slow down to 4.8% in 2022 with increasing risks of a hard-landing. While housing is leading the way to a slowdown, there are broad-based downward pressures – zero tolerance to COVID outbreaks, elevated inflation, regulatory crackdowns and tightening of credit conditions.

Bloomberg US government securities liquidity index shows a deterioration in liquidity conditions



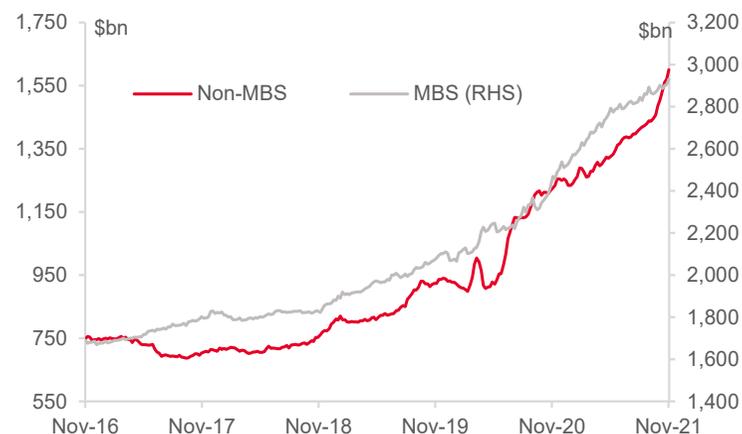
China credit impulse leads 10yT yield moves



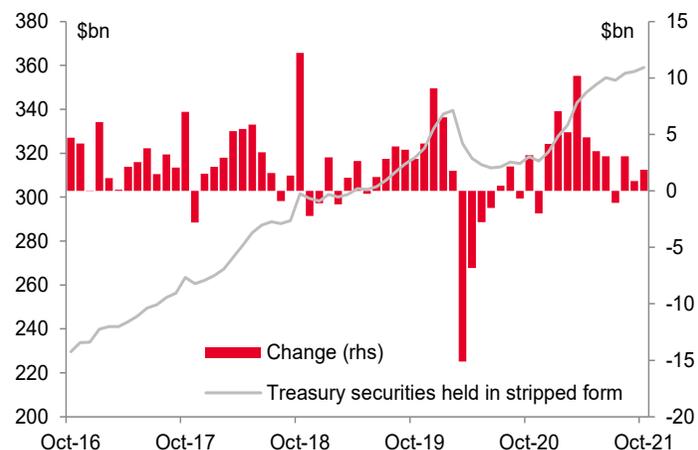
Source: SG Cross Asset Research/Rates, Bloomberg

AS THE FED TAPERS ... NEW BUYERS' STEP IN

Sharp rise in banks' non-MBS holdings in recent weeks



Treasuries held in stripped form steadily increasing



Foreigners have been net buyers of Treasuries in 2021

	September	2021	2020	2019
Japan	7.8	-36.9	-17.8	-12.8
China	-3.1	25.2	-34.0	-119.4
UK	17.1	59.5	66.7	149.5
Luxembourg	-3.6	-24.3	-57.5	-14.6
Ireland	-1.3	-9.0	-54.1	-40.9
Switzerland	-0.5	6.5	19.3	-3.9
Cayman Islands	-33.6	-117.1	-271.0	-86.3
Brazil	-0.4	-7.8	-4.4	-36.7
France	6.4	19.7	-39.6	40.9
Taiwan	1.3	-2.8	-0.7	-9.1
Others	11.3	100.6	-147.0	-0.2
Total	1.4	13.7	-540.0	-133.5

Japanese net investments in foreign sovereign bonds

	Sep-21	Aug-21	Jul-21	Jun-21
US	3,770	-551	-764	1,509
Canada	77	-14	93	-118
Australia	-46	-139	-155	-287
Germany	145	69	-438	-129
France	381	-59	-213	-52
Italy	83	-54	376	-258
Netherlands	132	5	13	-62
UK	-200	35	-59	-240
Denmark	102	-13	-50	93
Switzerland	2	0	0	0
Hong Kong	0	1	1	1
Sweden	2	13	-12	-62
Others	226	-198	99	551
Total	4,673	-906	-1,109	945

Source: SG Cross Asset Research/Rates, Bloomberg

SCALING BACK ISSUANCE

Estimates for deficits and Treasury issuance

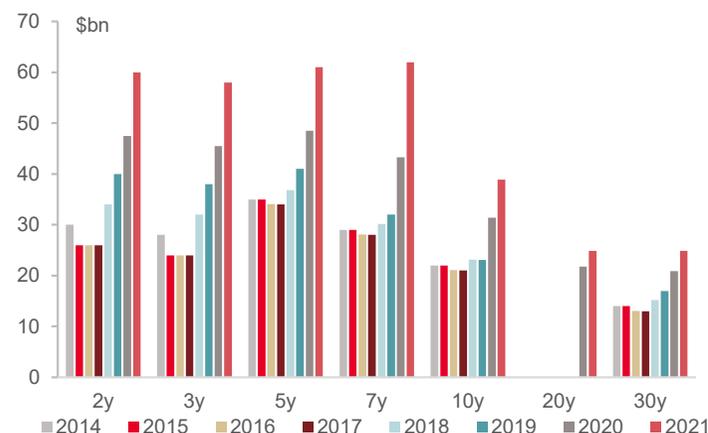
Deficit Estimate (\$bn)

	Primary Dealers	CBO	OMB
FY 2022	1,350	1,153	1,660
FY 2023	1,200	789	1,316
FY 2024	1,000	753	1,331

Net Marketable Borrowing Estimate (\$bn)

	Primary Dealers	CBO	OMB
FY 2022	1,805	1,380	1,921
FY 2023	1,129	764	1,363
FY 2024	1,075	803	1,350

Treasury auction sizes – annual average



Treasury issuance forecasts for CY22

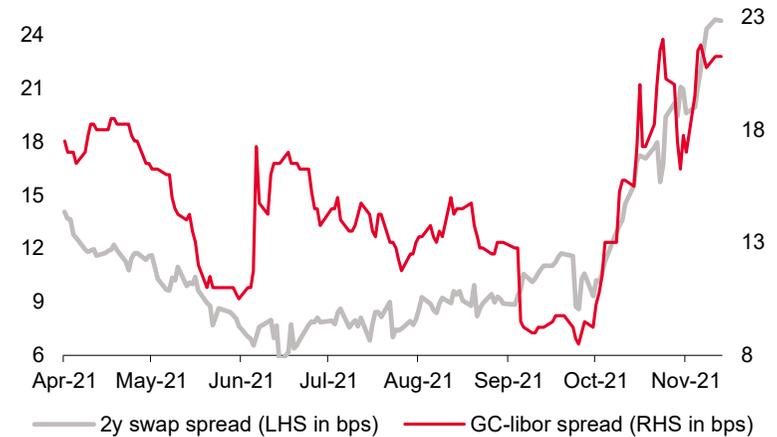
CY22	2y	3y	5y	7y	10y	20y	30y	FRN	5y TIPS	10y TIPS	30y TIPS	Gross issuance	Maturing ex-Fed	Net issuance
January	54	52	55	53	36	20	22	26		16		334	206	128
February	52	50	53	50	37	19	23	22			9	315	140	175
March	50	48	51	47	34	16	20	22		14		302	101	201
April	48	46	49	44	34	16	20	24	19			300	218	82
May	46	44	47	42	37	19	23	22		14		294	139	155
June	46	44	47	42	34	16	20	22	17			288	109	179
July	46	44	47	42	34	16	20	24		16		289	222	67
August	46	44	47	42	37	19	23	22			8	288	148	140
September	46	44	47	42	34	16	20	22		14		285	121	164
October	46	44	47	42	34	16	20	24	19			292	192	100
November	46	44	47	42	37	19	23	22		14		294	155	139
December	46	44	47	42	34	16	20	22	17			288	121	167
Total	572	548	584	530	422	208	254	274	72	88	17	3,569	1873	1696

SWAP SPREADS

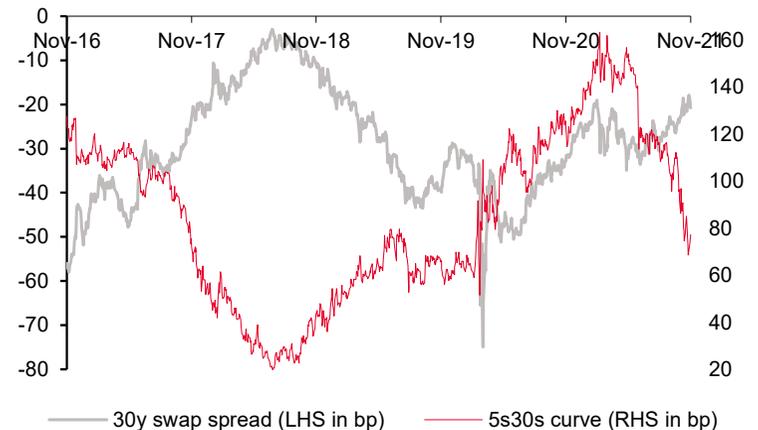
Modest reversal of widening

- Spreads across the curve widened meaningfully this year. While we had been expecting spreads to widen, the recent widening has been well above our forecasts.
- With tapering underway, the additional supply is likely to contribute to the narrowing pressure on spreads.
- Front-end swap spreads too wide. the GC-Libor spread has widened dramatically.
- 10y and 30y spreads - changes to the supplementary leverage ratio, convexity hedging, 5s30s flattening are key considerations.
- **Don't forget, no more Libor!**

2y swap spread widens as GC-Libor spread widens dramatically with market pricing of hikes



30y swap spread widening might run out steam if the 5s30s curve steepens



Source: SG Cross Asset Research/Rates, Bloomberg

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