BNY

MACRO MORNING BRIEFING

iFlow

January 13, 2025

Strong December Jobs Report and What's Driving Bond Yields

- The jobs data were uniformly strong – yields and USD rise further
- Fiscal and other risk worries are driving yields higher
- Dollar holdings are finally back to neutral

Labor market robust

According to the establishment survey, the US labor market added 256k jobs in December, a number that well exceeded consensus expectations of 165k. Furthermore, the household survey, which had been running weaker than the establishment survey for almost all of 2024, posted a remarkable increase in employment of 478k, rounding out what was in almost all respects a strong print, allaying concerns that the job market is slowing.

This suggests that the Fed will remain on hold for the foreseeable future, in our opinion, pending developments in the – currently sticky – inflation data. The market reaction was consistent with this view, with the dollar rising on the report, and 10y yields reaching well above 4.7%. We still view the march to 5% yields as unlikely to relent and think the data and market reaction confirm our long-held view in favor of curve steepeners.

Among the highlights of the labor market report, in addition to the headline numbers from the establishment and household surveys:

• The labor force increased in total by 243k, leading to a labor force participation rate of 62.5%, unchanged from the last two months
• This brought the unemployment rate down, as employment growth outpaced labor force

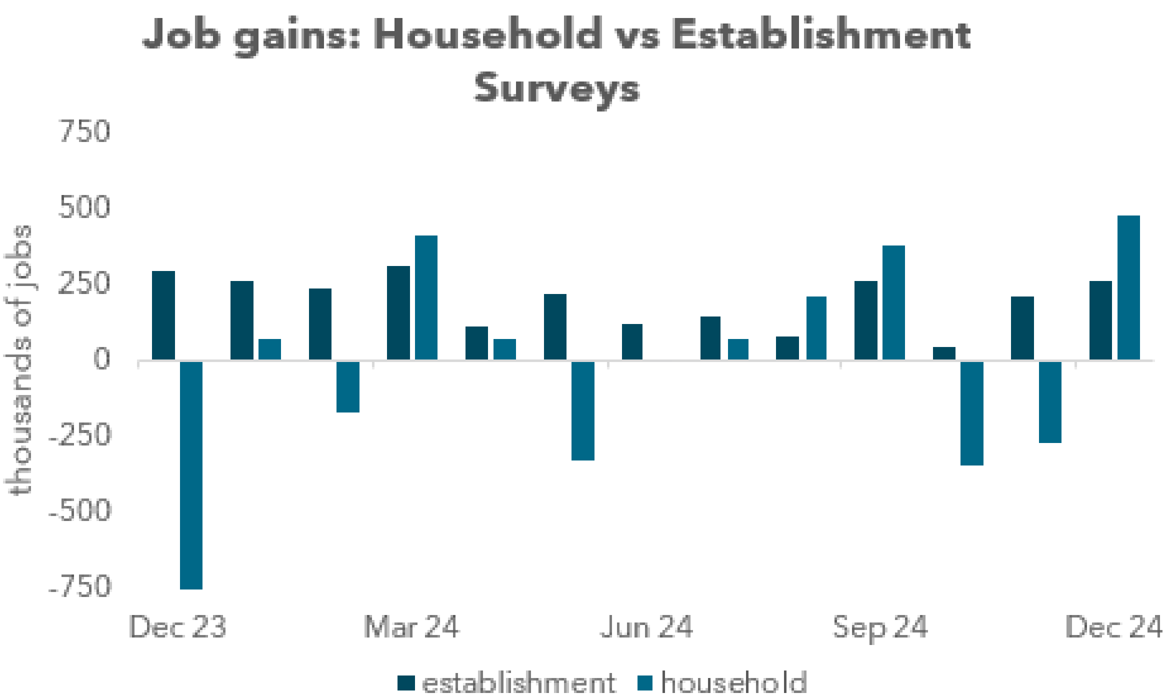
growth. The 4.1% reported was one-tenth of a point below expectations and also below last month's 4.2%. The current unemployment rate is at it its lowest level since May 2024

• The sectoral distribution of job gains was relatively broad. Of the 15 main sectors, only four declined, and in those cases the drop-offs were modest. Of particular note is the manufacturing sector; jobs declined by 13k, and the sector completed the year down 84k positions after posting 7 months of negative jobs growth out of the 12 months of 2024

Exhibit #1 shows the monthly increases in the number of jobs reported by the establishment survey as well as the number of newly employed persons from the household survey. Since last December, the latter was below the former nine times. In that period, the household survey was stronger than the establishment only three times, including this past December.

Market pricing for Fed rates reacted on the data release, with the December 2025 implied policy rate up to just above 4% (implying two cuts this year – matching Fed projections) from 3.85% on Thursday. We concur with the market and the FOMC, but we are somewhat unsure of the timing of the next cut. With the labor market posting such a robust result Friday, we are convinced that developments in consumer inflation will be determinative of policy, meaning next week's CPI release will be key. Our base case is for a cut by the June meeting, which about where the market has priced June rates.

Exhibit #1: Household Survey Snaps Back



Source: BNY Markets, Bureau of Labor Statistics

Neither policy expectations nor inflation pushing yields higher – think fiscal risk

What's been driving bond yields higher in recent weeks? It's tempting to argue that a reassessment of the Federal Reserve rates path in a more hawkish (or less dovish) direction has been chiefly responsible, although we don't agree. A decomposition of the drivers of the 10y yield show that real rates, especially a reassessment of the riskiness of US long maturity bonds, is the main driver.

We can disentangle these main drivers by examining Exhibit #2 below. We show the 10y yield (dark blue line), the 2y yields (black line), the 5y5y USD inflation swap (light blue) and the 10y US Treasury term premium as calculated and provided by the New York Fed (gray). First, note the difference between the 10y and 2y yields over the last 12 months. Until around September, the latter was running higher than the former, indicating an inverted yield curve. After that, the 10y started to move higher than the 2y note yield, and the curve has uninverted and is currently posting between 30 and 40bp of positive slope. The relative stability in the 2y yield throughout the autumn of 2024 and into this year implies to us that monetary policy expectations haven't changed in the medium-term very much. The 10y yield has been rising despite a similar rise in the 2y yield which is quite sensitive to expectations for policy rates. The move in the curve is taking place almost entirely at the long end.

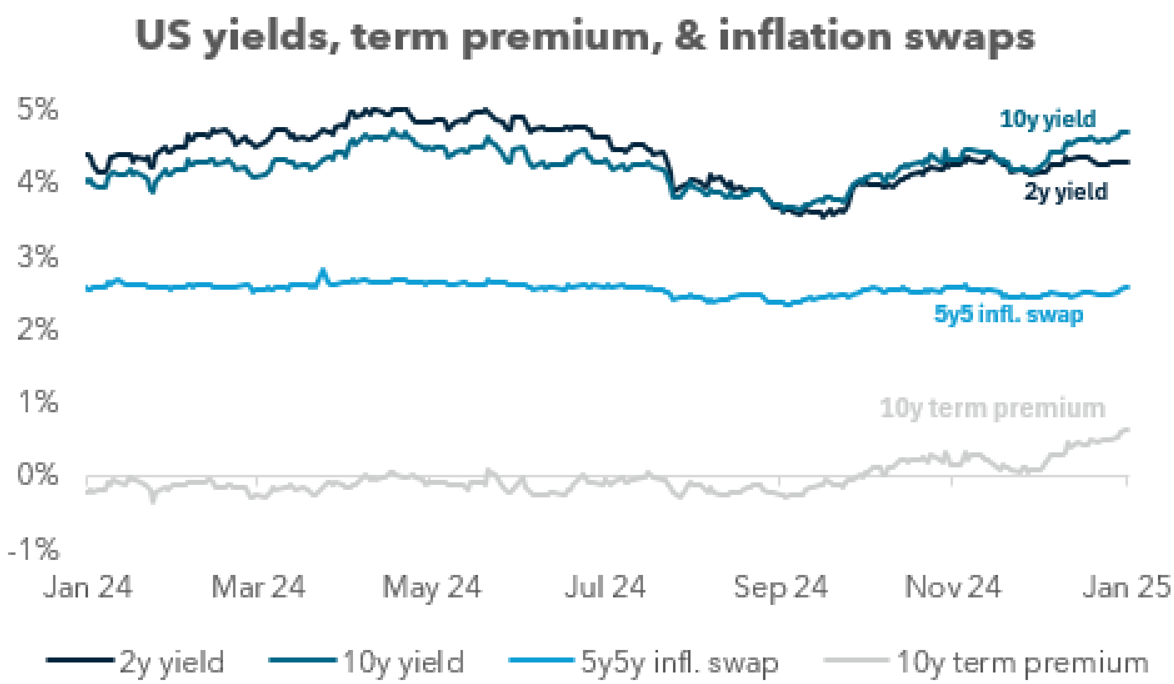
What about inflation expectations? Are anticipated tariff moves and immigration policy driving inflation expectations higher, moving the nominal 10y yield up along with them? Again, a look at the chart discourages this argument. 5y5y inflation swaps are closely monitored by the Fed as an important market-based measure of inflation expectations. If they were to rise, the nominal 10y note yield would also rise to reflect this. While the 10y is indeed moving higher, the inflation swaps are steady – almost completely flat over the past 12 months. We think this indicates that inflation fears aren't driving yields higher.

Finally, we can see that almost all of the increase in the nominal bond yield since its lows around the end of September is due to a rising term premium. The term premium is a measure of compensation (related to perceived riskiness) that is required by investors to lend to the US government – it includes default risk, time value of money considerations, liquidity and other risks associated with a long holding period. In other words, the real 10y yield is rising, considering inflation expectations are flat, and monetary policy expectations haven't changed at all, yet the term premium has risen from -30bp on September 12 to +61bp on

Friday last week. Real rates rise either due to expectations of strong growth and/or budget financing fears.

It is true that on Friday the University of Michigan Survey of Consumer Sentiment reported markedly higher inflation expectations. For both 1-year and 5- to 10-year inflation, respondents' expectations rose to 3.3%, up from 2.8% and 3.0%, respectively. While until now, the increase in 10y yields has not, in our opinion as argued above, been due to rising expectations, we shouldn't rule out the inflation angle from becoming a meaningful driver of even further steepening. But for the moment, market-based measures remain under control, and we interpret movements at the long end of the curve to be more risk-based than inflation or policy-driven. The bond vigilantes look to be waking up.

Exhibit #2: A Simple Bond Yield Decomposition



Source: BNY Markets, Federal Reserve Bank of New York, Bloomberg

Trade-weighted dollar positions back to neutral

Our iFlow-based measure of US trade-weighted dollar positioning has moved to dead neutral in recent days. It appears as if the move in the BIS nominal effective broad exchange rate from around 104 in late September to above 110 now (+6.7%) has finally been sufficient to eliminate what had been a persistent – if steadily closing – underweight in the broad dollar.

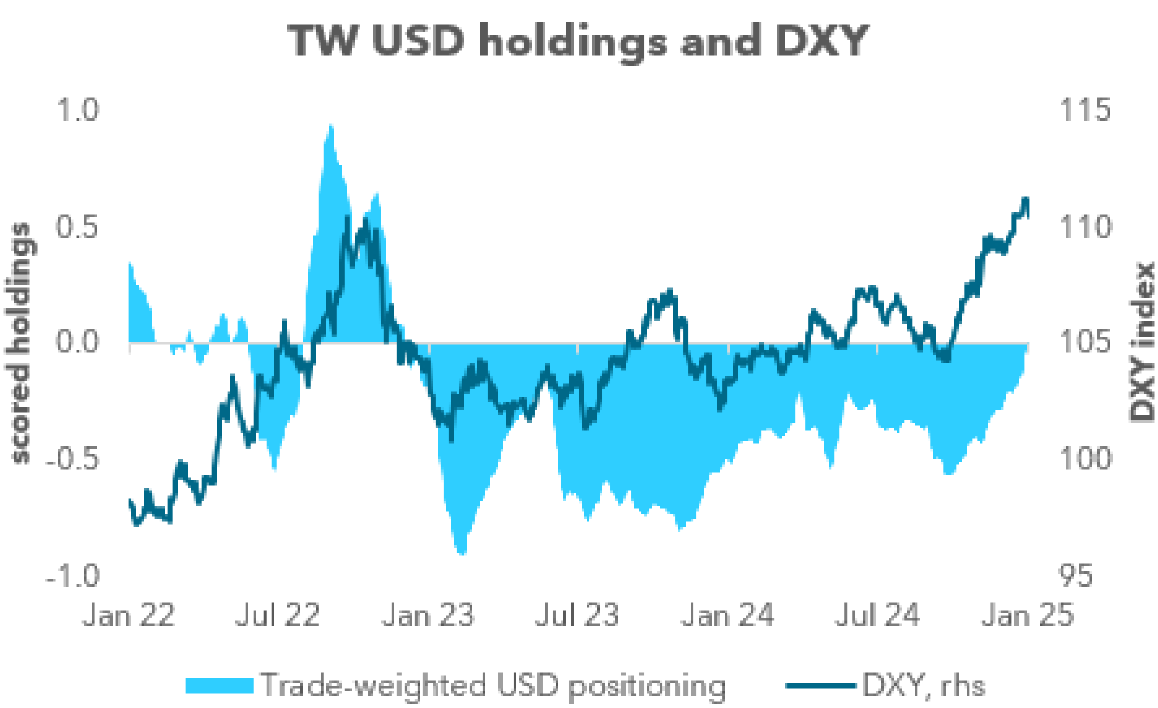
Our dollar holdings series is simply the trade-weighted sum of or holdings indicators for all the non-USD currencies we monitor in iFlow.

Exhibit #3 shows the evolution of traded-weighted USD positions going back to 2022. According to our data, for most of the post-pandemic period, investors in aggregate had been underweight the greenback, even as the broad data fluctuated in a pretty elevated range.

Many of the overweights in currencies like the MXN, BRL, and HUF have been unwound over the last eight weeks or so, although some overweight (for example, TRY) persist. Given the trade-weighting of our dollar positioning index, MXN and CAD play large roles in the computation of aggregate dollar holdings, due to their heavy US trade exposure. These two currencies weigh prominently in the index, and their previous overweights had an exaggerated effect on the aggregate measure. As mentioned above MXN holdings were nearly two standard deviations overweight in early autumn, almost the same for CAD. Holdings for both currencies remain long, although well below where they have been, but they have come in a great deal in recent months.

We think there is still room for elevated holdings of MXN, CAD and other currencies to be reduced, especially given the likelihood of aggressive tariffs on both Mexico and Canada. Thus, an evening out of the previous USD underweight is not prohibitive of further dollar appreciation, especially given the economic and monetary policy fundamentals.

Exhibit #3: Dollar Holdings No Longer Underweight



Source: BNY Markets, iFlow

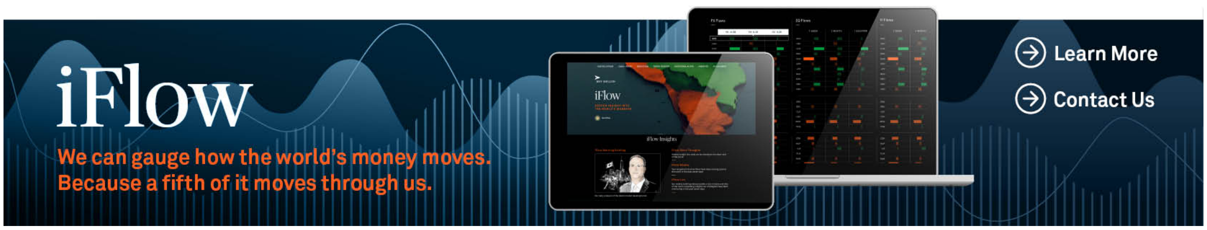
Please direct questions or comments to: iFlow@bny.com

Disclaimer & Disclosures

JOHN VELIS
AMERICAS MACRO STRATEGIST

CONTACT JOHN

Can't see the email? View online



This message was sent from an unmonitored email box. Please do not reply to this message.

.