bridport & co

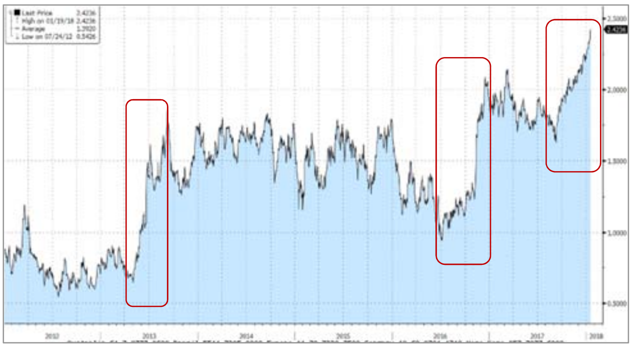
US yields – A tactical opportunity

Market Focus
January 22, 2018

by Caroline Weber, CFA

For the third time in five years, USD yields have jumped sharply in just a few months. While such a move is not exceptional, it always raises some questions. What are the reasons for such a rise? How long may it last? Are Treasuries cheap now?

USD 5 yr Treasury yield evolution



Source: Bloomberg

The bond market – A Vulcanian eruption

Before answering the above questions, we would like to make a small digression as we think it adds value to remind the current environment in bond markets.

It seems the description of the market environment we outlined in our 2016 Q4 strategy is still relevant today.

"Everything looks quiet on the surface, but underground, pressures are rising and at some point, an eruption will occur. Equity and bond prices are hovering around record levels yet there is little conviction. As a result, markets are highly sensitive to bad news.

Investors need to determine which kind of eruption we will observe, and when. A Pelean eruption (one of the most violent, with glowing avalanches destroying almost all nearby life)? A Vulcanian type (a succession of violent but relatively short explosions)? Or just a slow lava flow, which is relatively easy to anticipate, and to some extent, negotiate? From our perspective, we expect a Vulcanian type eruption, however, we admit to having little idea on timing of the next eruptions."

While it is difficult to anticipate the eruptions, when they happen, it is quite easy to justify why investor sentiment has reversed and the key drivers of such a change.

USD bond market – So many headwinds

The current rising trend is relatively easily to justify when considering the many headwinds faced by the US Treasury market:

- The US tax law puts the economy on an **unsustainable fiscal** path and endangers stability, while the Trump government has not reached any long-term agreement on the **debt ceiling issue** and a US government shutdown started last Saturday. The creditworthiness of the United States has never been so weak during recent decades.

In their guidance, the Fed announced **three hikes** of 25 bps for 2018. While it is not an aggressive tightening, investors are clearly informed about the rising trend of the US rates and the attraction of USD bonds has clearly declined. In addition, the normalization of US monetary policy reduces the Fed's demand for Treasuries and Chinese and Japanese demand may not replace it. As a result, **demand may slow while the supply of US government debt will almost double to $1 trillion this year.**

- Recent **pressure on inflation** figures have also driven long-term rates up:
  - OPEC moves closer to its target of reducing global oil production and oil prices have hit the highest level since 2014 Q3.
  - The US domestic economy is strong and the low unemployment rate is adding pressure on wages.
  - The USD depreciation brings imported inflation into the US and blunts the effectiveness of the Fed's monetary policy to contain inflation.

Are Treasuries cheap now?

Now that US 5-yr and 10-yr Treasury yields have risen by more than 80 bps and 60 bps respectively in the past five months, investors may wonder if current yields are attractive or not. To answer to this question, we need to look at the real rates levels, not the nominal rates. **The real valuation of a bond market is reflected in the real rates** (nominal rates adjusted by the inflation rate).

While the USD 5-yr nominal yield has clearly reached a new high following the correction, the graph below shows us that it is not the case for the USD 5-yr real yields. While the 5-yr real rate is at the high-end of the trading range, it is not above the 2014 and 2015 highs.

USD 5-yr real rate evolution

Source: Bloomberg

This implies that current valuations may appear cheap when looking at the nominal rate, but it is **not confirmed by the real rate.** Our regular readers would know that the main target of the Fed is to bring back real rates consistently in the positive territory. Consequently, the recent correction is fully in line with the Fed's intention to normalize US financial conditions.

The recent correction - A tactical opportunity?

While we expect the rising long-term trend to continue, a short term reversal is highly probable. As a result, **such valuation may offer a tactical opportunity for investors with a 3 to 6 month time horizon** as the convergence of so many headwinds may not last and are already largely priced in.

- With the shutdown of the US government announced this weekend, we may expect the old adage "sell the rumors and buy the fact" to be realized once again.
- The near-term inflation data may fall shot of market expectations.
- The bond market may also benefit from the TINA put (There Is No Alternative) as there is still a lot of cash waiting for investment opportunities.
- Finally, the US government and the Federal Reserve will be the biggest losers if interest rates overshoot. Consequently, **we expect the Fed to control the yield curve if necessary.**

Finally, our market view may be confirmed by simple technical analysis. While the long-term analysis may conclude that US Yields are at risk of breaking the upper limit of the declining trend-channel since 1985, zooming in on the shorter term, the conclusion is not that clear and a return to 2.25%, or even 2.0%, before continuing the rally in rates is possible.

USD 10-yr Treasury yield: long-term trend

Source: Bloomberg & bridport's analysis (Alessandro Colic)

USD 10-yr Treasury yield: zoom on the shorter term

Source: Bloomberg & bridport's analysis (Alessandro Colic)

Our conclusions

While the move has been very quick and largely harmful for portfolios, our regular readers would know that a rising trend for US rates over the next years is part of our scenario. As a result, the recent correction in USD yields does not change our strategic view and we maintain our barbell (FRNs + 10 years). A barbell should still prove rewarding as the short-end of the curve should benefit from the tightening of monetary policy, whilst the long-end of the curve, driven by the anticipation of the next slowdown, is more stable. However, compared with the past cycle, the outperformance of the long-end may be limited by the Fed's tapering program.

The current correction may only offer a tactical opportunity. Investors with a relatively short time horizon may buy long-term bonds with the objective to realize a capital gain within the next 3 to 6 months and long-term investors may benefit from this opportunity to lengthen duration if they need to.