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This spike in Treasury yields has the looks of hedging activity

◆ The yield on 10-year US Treasuries breached 1.31% yesterday, closing at the highest in a year.

◆ The 10.6 basis points rise in the benchmark yield was the biggest one-day move since early November.

◆ The 10-year swap yield traded even higher, at almost 1.4%, and the difference between the derivative and Treasury yields suggest hedging activity may have ramped up.

◆ The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight alternatives.



US Treasury markets are usually quite boring. A small move can mean a lot so the whole world takes notice when a big move like yesterday's happens, and the ripple effects are felt across asset classes all over the globe.

After rising 8.5 basis points on Thursday and Friday, the yield on the 10-year US Treasury spiked 10.6 basis points to 1.31% yesterday, the biggest one-day move since 11 November.

Partly as a result of that, US stock markets had their first negative day in three and only the third so far this month. Gold prices also dropped below US\$1,800/oz.

Higher US Treasury yields can sometimes prompt some investors to rebalance their portfolios by reducing their equities exposure and increasing their bond exposure marginally. This may have been the driver, as, today, the yield on the 10-year US Treasuries was retreating 1 basis point at the time of writing.

Apart from pension funds selling some shares to buy bonds, the higher US Treasury yields also attract international investors, and that has more wide-ranging impacts. The yields on the benchmark 10-year bonds of Austria, New Zealand, Spain and Sweden have increased 16, 18, 14 and 12 basis points respectively only in the past week. This signals that some investors have been selling these bonds.

Some of the money from the sale of these bonds could be finding its way into the United States to buy US Treasuries. That is being reflected in the value of the dollar index, which was rising 0.35% today, a big move compared to the five-year median 0.004% daily move for the index.

A stronger dollar also impacts EM, which is correlated with the value of the US currency. Finally, gold prices also react negatively to the stronger dollar. Plus gold offers no yield and if Treasuries offer higher returns they may attract investments that were in the yellow metal.

The spread between 10-year US Treasuries and swaps has spiked, a sign of hedging

The demand generated by these investors moving back into US Treasuries suggests there could be a cap for the rise in Treasury yields. Furthermore, there are signs suggesting the rapid rise in yields in the past few days was partly caused by hedging activity, which can be reversed.

The yield on the 10-year swaps, for instance, was close to 1.4% yesterday, and their spread to the 10-year US Treasuries they relate to, increased to 9.4 basis points, the highest since 2015. That suggests a lot of investors selling swaps, which, in its turn, signals at hedging activity. This could be because some investors are preparing for the possibility of higher inflation ahead. If this is the case, the move in Treasuries will soon fizzle, and the risk rally can resume.

Investment Strategy Update

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