Investment Strategy Update

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The rise in US Treasury yields could temporarily impact EM

♦ The hedging of mortgage portfolios could push long-term Treasury yields a bit higher this week.

♦ The MSCI EM Currency Index has started to react to higher US dollar yields, retreating from a record high.

♦ A falling equity yield premium could also prompt some temporary rotation back into bonds.

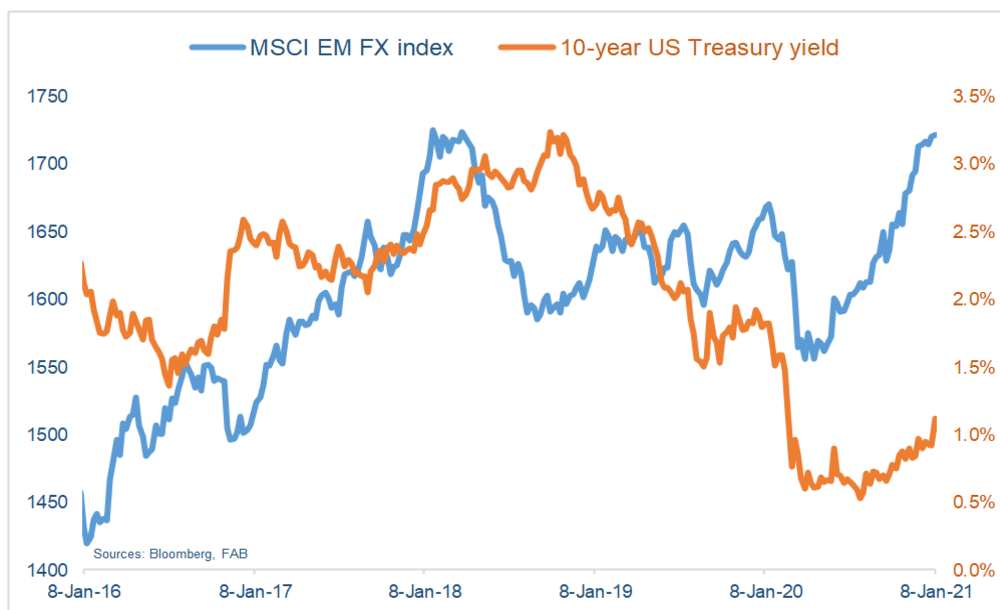
♦ Ultimately, however, this uptick in Treasury yields should be short-lived, providing an opportunity to add long-duration, high-quality bonds to portfolios.

♦ The FAB AAC has a neutral position in equities, and is slightly overweight in IG and EM bonds, and gold.

Asian trading of US Treasuries was closed today, due to a holiday in Japan, but given the activity in the market last week it looked like yields on long-term bonds would continue to rise. If that continues throughout this week, it could impact several asset classes, EM in particular.

There were more than US$16 trillion in mortgage portfolios outstanding in the US at the end of 2019, according to the latest Federal Reserve data. A significant part of that is traded by active investors, who keep a tight control on their expected cash flows. When rates move upwards and they expect fewer people to refinance, they short the 10-year Treasury.

Because the 10-year Treasury yield is the benchmark for most mortgages in the US, higher yields on that bond result in fewer people refinancing mortgages. That means when mortgage investors short 10-year US Treasuries to compensate for fewer refinancings, they also prompt even fewer people to refinance their mortgages. This creates a short-term spiral.



At some point, the higher yields attract buyers, who stop this self-fulfilling cycle. Also, the Federal Reserve can be expected to step in and buy more long-dated bonds if the up-move in yields is very sharp and starts to have an impact on broader markets or on mortgage costs.

In the meantime, bonds, particularly investment-grade and local currency emerging market ones, may suffer a short-term sell-off. The Bloomberg Barclays EM US Dollar bond index has dropped 0.84% since this year so far, just as the yield on the 10-year US Treasury has risen 20 basis points. In the past week the MSCI EM Currencies Index has also started to retreat from a record high hit at year-end.

Both of these indices tend to take time to fully reflect a sharp change in Treasury yields. This means that even if Treasury yields stabilize, these two asset classes could still have some weakness ahead.

The MSCI EM FX index has retreated from a record high as US Treasury yields rise

If the up-move in Treasury yields continues, as may be the case, the price weakness could spread to other asset classes. One of the drivers for equities has been the relative value of higher expected earnings compared to ultra-low rates. If redemption yields on the safest assets continue to move higher, some of the money from pension funds could move back into bonds from equities.

In the end, the move is likely to be short-lived and represents a good opportunity to buy some high-quality bonds, especially within emerging markets. And equities will continue to enjoy the tailwind of low rates.

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