Investment Weekly

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21 February, 2021

Cheaper Treasuries could prompt some portfolio rebalancing

♦ The recent sell-off in government bonds across the world is making the safest assets relatively more attractive.

♦ Even on a hedged basis, long-term US Treasuries are looking more attractive to foreign investors.

♦ The price of 10-year US Treasuries has dropped 6.8% since the first week of August.

♦ This may cap the rise in long-term Treasury yields for now, but the rebirth of inflation expectations suggest investors may continue to favour risk assets versus government bonds.

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

When evaluating how much of an asset class to hold, allocators look at its correlation with others, its drivers and its risk/reward prospects. Government bonds are always an important part of any diversified portfolio because they usually move in the opposite direction to other risk assets. US Treasuries, for instance, tend to move higher when risk asset prices fall.

As for its drivers, economic growth and inflation expectations usually help to determine the direction of market interest rates and, by proxy, Treasuries.

When the growth outlook is promising and there are increased expectations of higher inflation, investors tend to require a higher return for holding US Treasuries, or any government bond for that matter. Higher yields translate into lower bond prices. And the longer the maturity of the bond, the more it drops as market yields rise.

This is partly why the benchmark 10-year US Treasury bond has lost about 6.8% since it peaked on 4 August. In the same period, the yield on this bond went from about 0.51% to 1.34% as of Friday, the highest level in a year.

The result of such a sharp move is that strategists and asset allocators can now say that government bonds look more attractive than they did a little while ago. This may prompt some rebalancing of portfolios in the next month or so which could favour bonds for the time being.

This move is likely to be marginal and probably will not shift the overall direction of most asset classes. Stocks may have already started to undergo the process.

Last week, the S&P 500 lost ground in every trading session. The movements were small, so the index ended the week only 0.71% lower. The fall was more pronounced in the small-cap-focused Russell 2000, which dropped 0.99%.

The prices of the benchmark 10-year US Treasuries have fallen 6.8% since August

This outflow from stocks has not found its way into government bonds yet, however. The yield on 10-year US Treasuries rose 12.8 basis points last week, bringing the year-to-date move in the measure to nearly 43 basis points.

Such a sharp move, however, is making what is considered in financial theory the safest asset more attractive. So alluring, that it seems to have started enticing more foreign investors.

The yields on the 10-year bonds of Canada, New Zealand, UK and Sweden have increased by 18, 13.5, 12.7 and 8.4 basis points respectively in the past week. Some of these are carry-trade favourites and signal some global investors have been selling these bonds.

Some of this money could eventually find its way into the US to buy Treasuries. That could be reflected in the value of the dollar index. The greenback has seen more volatility in the past couple of weeks amid a seeming tug-of-war between investors who expect the currency to drop as a result of all the fiscal stimulus, and international investors seeking higher yields in US Treasuries.

The other asset that is sensitive to Treasury yields is gold. The yellow metal has close to a 20% correlation with US Treasuries over the long-term, so when yields rise, it tends to suffer too. This makes sense, as some investors may find it more attractive to park their money in Treasuries and earn some return instead of in gold, which pays no coupons.

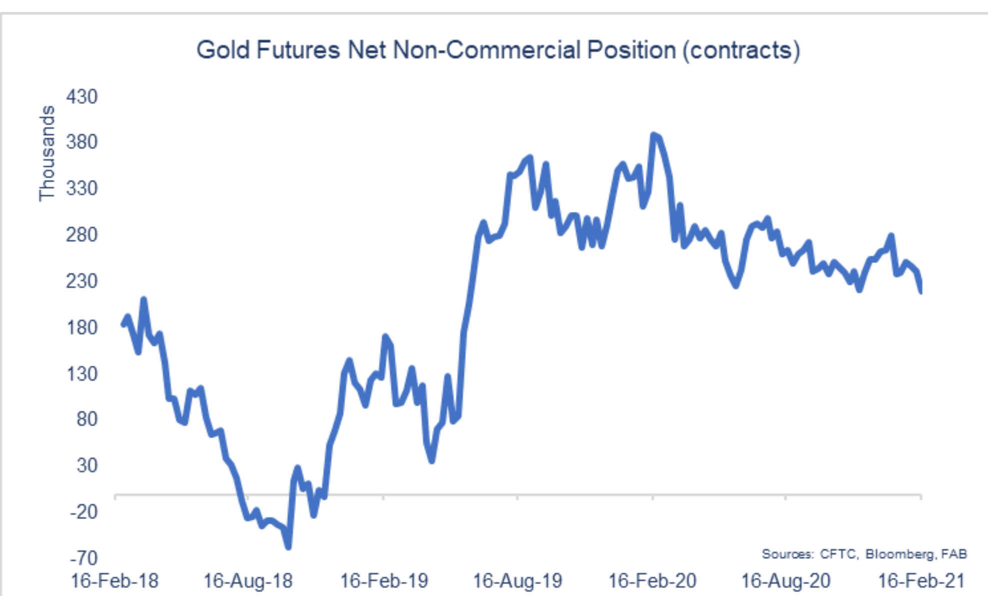
Many investors remain bullish on the metal as indicated by speculative positions in future, but that excitement has recently waned. As of 16 February, there were 219,969 more long speculative contracts in gold than short positions. This was far less than the 386,392 net long position recorded on 25 February, 2020, the recent peak for this measure, and was the smallest net long position since June, 2019. The recent drop in gold prices goes hand-in-hand with the rise in Treasury yields, as it should, given that both are haven assets.

The combined pressure of investors who may go into government bonds using money raised from selling stocks and other risk assets, and even gold, suggests there could be a cap for the rise in Treasury yields, at least for the time being. Furthermore, there are signs that the rapid rise in yields recently was partly caused by hedging activity, which can be reversed.

The yield on the 10-year swaps, for instance, was above 1.42% on Friday and their spread to the 10-year US Treasuries they relate to increased to more than nine basis points, the highest since 2015. That suggests a lot of investors selling swaps, which in turn signals hedging activity. This could be because some investors are preparing for the possibility of higher inflation ahead.

That hedging may be reaching an end, for now, judging by the Treasury Inflation-Protected Securities (TIPS). In the past week, the yield on the 30-year TIPS rose 28 basis points, signaling less demand for inflation hedging. The move left the yield over inflation on the security positive for the first time since June.

Speculative positions in gold futures remain bullish but are turning progressively less so



The other TIPS maturities, however, continue to offer negative yields, which suggests that investors expect inflation to outpace the yield on conventional Treasuries. That is reflected in the inflation breakeven rate, which is calculated by subtracting the conventional Treasury yield from the inflation-protected one. The five-year breakeven rate stands at 2.31%.

There is one asset class, in particular, which tends to benefit from higher inflation, even if Treasury yields rise as a result: commodities. The Bloomberg Commodity index is already up 9.28% so far this year and rose 1.47% last week alone.

Part of that rise was the result of a spike in oil prices as a deep freeze in the south of the US stalled shale oil production taking out as many as 4 million barrels/day from the market. West Texas Intermediate crude, which is produced and marketed in the US, closed at a 13-month high of US$61.14/barrel on Wednesday, before it started to retreat. The contract finished the week below US$60/barrel.

Other areas of the raw materials space continue to log new highs. Iron ore reversed a Lunar New Year dip and moved up by up to 4% after Chinese traders returned to their desks. Copper rose 4.36% on Friday alone, also on the back of returning investors in the East.

The red metal, which is often considered a good barometer of future economic growth and demand for construction materials, has seen its price rise 93.44% to US$8,946.75 a ton since 23 March, when its price bottomed most recently.

In a similar vein to what breakeven rates signal, the ratio of copper to gold is near its highest since May 2019. That means investors are looking more closely at the metal that tends to do well in inflationary, high-growth environments to the detriment of the metal that is associated with financial safety.

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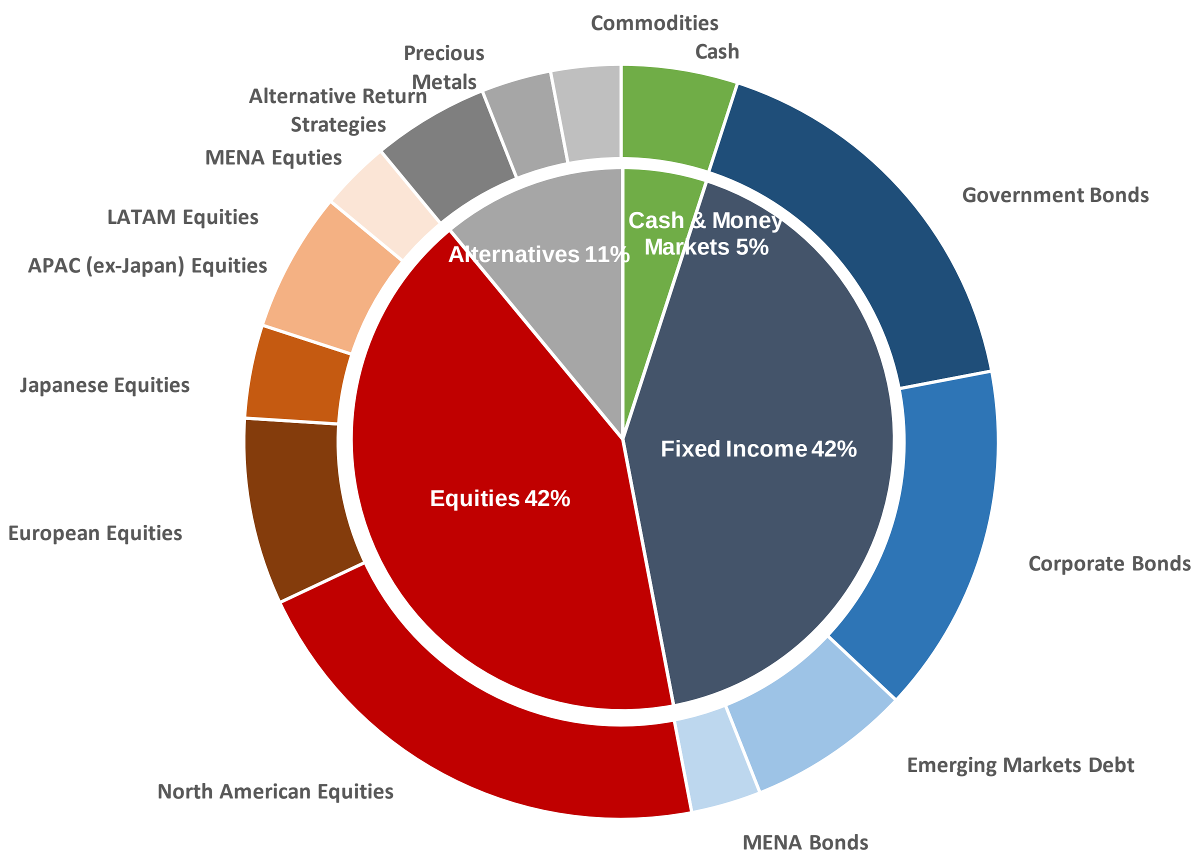
Current Tactical Asset Allocation



Asset Class	Positioning	Detail
Cash	Neutral	Moved into overweight equities position.
Fixed Income	Overweight	Keeping slightly overweight focused on EM dollar debt and corporate investment grade bonds
Equities	Overweight	Slightly overweight Japanese, US and Asia ex-Japan stock markets.
Alternatives	Underweight	However, still marginally overweight in precious metals

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