Investment Weekly

For inquiries related to this article, please contact:

Alain.Marckus@bankfab.com
Christofer.Langner@bankfab.com

28 February, 2021

As Treasury rout seems to peak, equities may climb again

- **While there are technical factors that could extend the Treasury sell-off in the short-term, it looks to have peaked.**
- **Large short positions in US Treasuries suggest any shift in market dynamics could prompt a short squeeze and a rally in bond markets.**
- **This week, investors will be paying close attention to Federal Reserve speakers, Treasury auctions, and the non-farm payrolls data in the US.**
- **Given the strength of the economic recovery markets are hinting at, the FAB Asset Allocation Committee has increased its overweight in equities through broad emerging markets.**
- **The FAB AAC is overweight in equities, IG and EM bonds, and gold, and is underweight in alternatives.**

US Treasuries are usually considered one of the safest corners of global markets, but last week most of the excitement was happening in that space.

While the sharp move higher in the prices of long maturity Treasuries on Friday seemed like there was some short-covering, there are still plenty of short positions outstanding. On Friday, the yield on the 10-year US Treasury dropped 11.5 basis points, to close just above 1.40%, after having flirted with 1.61% on Thursday. Yet, there are still 215,000 more short derivatives contracts than long for ultra-long US Treasuries.

This, along with a very large net short position in VIX futures (down-bets in equity volatility) suggest there could be very sudden moves in markets.

Whether speculators will be rewarded for the net short position depends partly on what Federal Reserve officials say this week. Several officials, including Chairman Jerome Powell, are set to speak, ahead of a 10-day quiet period before the FOMC meeting, on 17 March.

If Fed officials continue to express comfort with higher long-dated Treasury yields, some investors may feel emboldened to continue to short these bonds and prolong the sell-off. If, however, the officials signal that they are becoming concerned about the impact of higher long-term yields this could prompt a short-squeeze.

While bond and equity volatility do not necessarily move together, the large short position on VIX futures could mean bond jitters may spill over into stocks. There were 162,918 more short than long contracts on VIX futures on 23 February, according to the Commodities and Futures Trading Commission, the largest net short position in a year for the contract.

The difference in yields of two- and 30-year US Treasuries has hit the highest since 2016

The VIX spiked 7.55 points on Thursday, to 28.89. It retreated less than one point on Friday, to close at 27.95, suggesting some of these short positions could be hurting. When a heavily-shorted asset rises, bearish traders may be compelled to buy to curb losses, prompting a further rise in price. In the case of the VIX, more buying means more stock market volatility.

Higher VIX levels would be consistent with lower Treasury yields, as volatility in the stock markets tends to translate into more bond buying. Yet the trends that kick-started the bond selling remain in place.

Part of the reason for higher yields in long-dated US Treasuries is confidence that the US is in the beginning of a strong economic recovery, which could raise inflation. Fed officials, including Chairman Jerome Powell, reflected that view in remarks last week,

Indeed, higher long-term yields provide a bigger incentive for banks to lend, and that helps to fuel faster growth. However, if these yields rise too much, that could make long-term borrowing too costly and undermine the recovery. The European Central Bank, for instance, already expressed that exact concern last week when Chair Christine Lagarde said the institution was watching government bond yields closely.

Fed officials have also said they are not worried about inflation, and there, too, they have little reason for concern. Markets could still test that notion, especially as a new stimulus package is expected to be approved this week in the US.

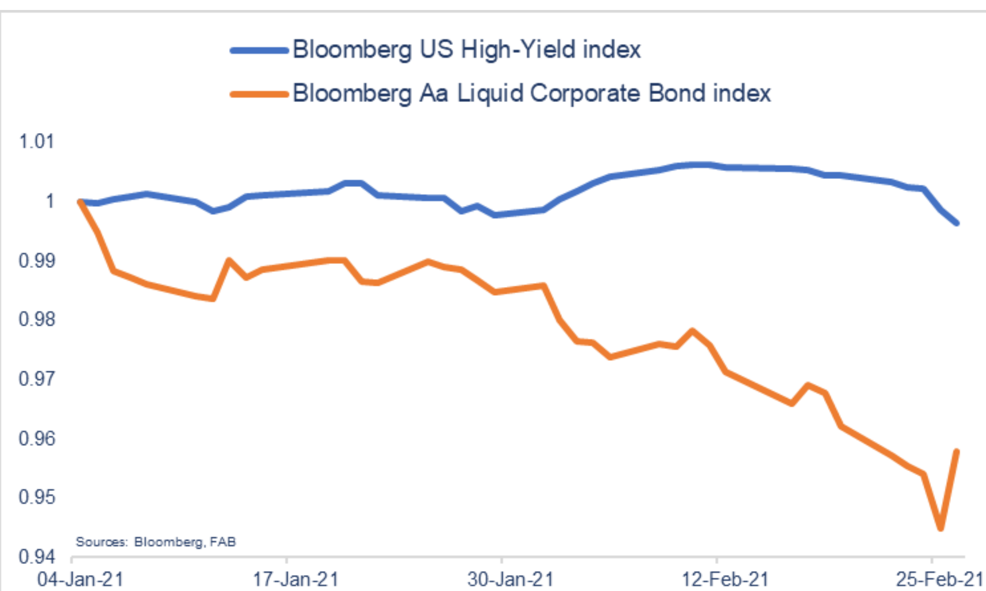
Assuming a US$1.9 trillion stimulus package, the total amount of fiscal stimulus in the past year alone would come to US$5.4 trillion, or 25% of US GDP as at 31 December. This is an unprecedented amount of money and some economists are suggesting such an increase in the quantity of dollars in the economy could translate into inflation.

However it is not so simple. First of all, not all these dollars being 'printed' actually go into the economy. To put it in perspective, the US$3.5 trillion cumulative stimulus of last year has translated into a US$2 trillion increment in GDP. In other words, less than 60% of the extra money Washington mandated has so far flowed into the economy, with the rest probably going into investments.

If that pattern is repeated, the latest package could take the US economy to US$22.6 trillion by year-end, a year-on-year growth of 5%. The Conference Board, for instance, said this weekend they expect the country to grow 4.4% this year. This would be very healthy, and helps underpin the bullish position in risk assets that the FAB Asset Allocation Committee (AAC) has taken.

In a meeting on Thursday, the FAB AAC decided unanimously to increase its overweight position in equities at the expense of its cash position. That view is to be actioned via the broad emerging markets space, in which the AAC sees the most potential for capital gains.

Junk bonds have outperformed high-grade as investors favour more cyclical assets



EM stocks are particularly sensitive to global growth and if the US expands at a 4.4% pace, they are likely to do well. Yet, if the US economy had continued to expand at the same pace at which it was growing before the pandemic, it would have reached the end of this year at a size of US$23.6 trillion. That US$1 trillion difference is what economists call the 'output gap', the difference between what the economy is actually doing and what is actually possible.

An output gap can be disinflationary, and therefore might keep consumer prices on hold. To close the output gap, business spending and capacity utilization have to rise and unemployment has to fall. Fed projections suggest the US economy starts running hot when unemployment is below 4.1% — it is at 6.3% right now.

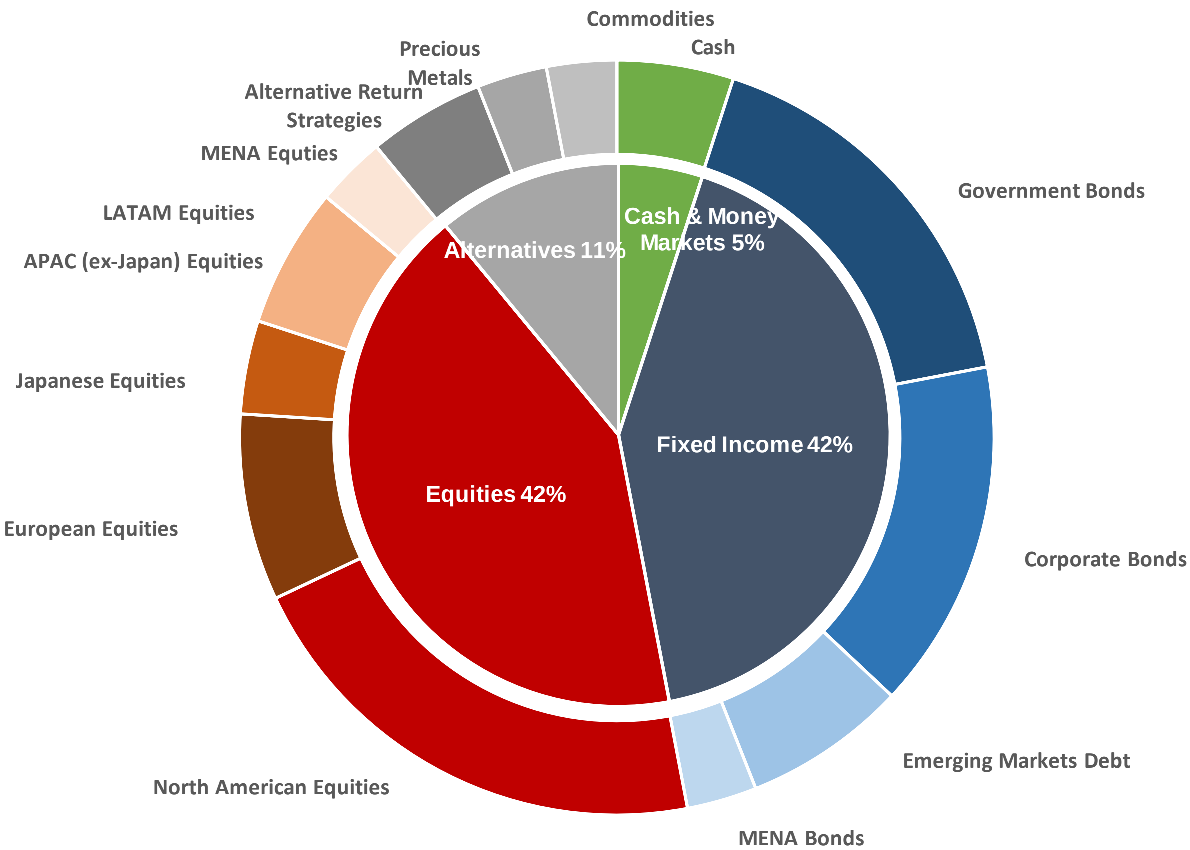
To go back below 4.1%, the US has to generate about 10 million jobs. Its long-term average monthly job creation is 136,000, so it could be three to four years before the labour market adds much pressure to inflation. Capacity utilization recently peaked at about 80%, and is currently below 76%, so there is no pressure there either.

That said, the US Consumer Price Inflation Index dropped to 255.4 in May, 2020. If it continues rising at the current rate, it will be in the 264 area in May, creating a one-time year-on-year inflation print of about 3.2%. That, however, is then likely to taper off, with inflation likely to trend back to 1.8%-1.9% year-on-year, below the Fed's target of 2% (unless the output gap is closed).

This means that, regardless of whatever volatility occurs this week, the current Goldilocks scenario of accelerating growth and low rates is likely to be around for a while. Accordingly, this is an excellent environment for risk assets to outperform.

Investment Weekly

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

بنـك أبـوظبـي الأول
FAB
First Abu Dhabi Bank