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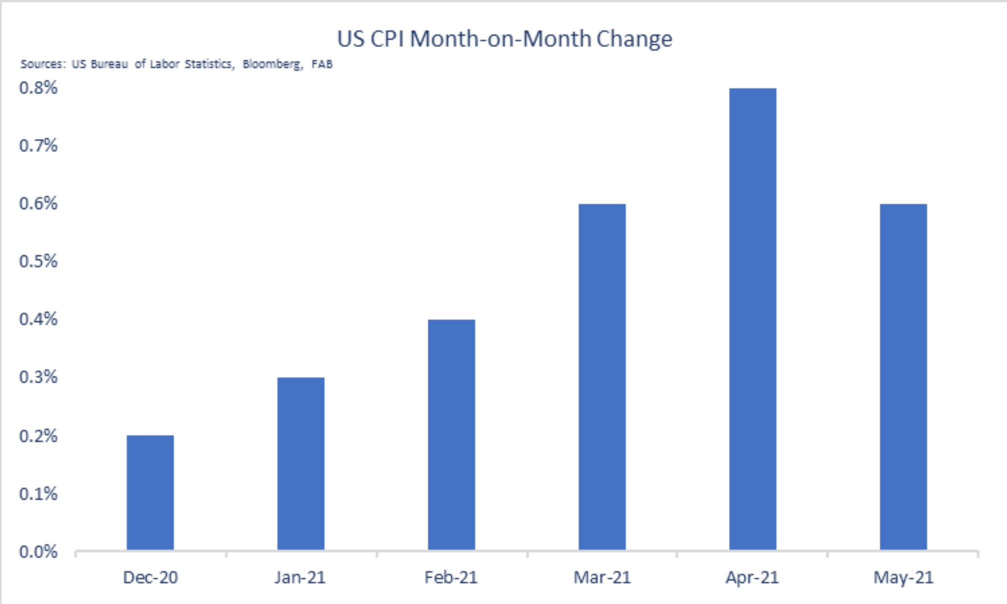
BEARISH POSITIONING IN BONDS UNRAVELS

June 13th 2021

- US consumer price inflation rose by 5% year-on-year in May, the fastest rise since August, 2008.
- The yield on 10-year US Treasuries fell by 10.2 basis points last week, despite the inflation number.
- Positioning ahead of the latest numbers and slowing economic momentum may help explain the unexpected bond market move.
- The FAB AAC is overweight in equities, IG and EM bonds. It is also underweight cash and neutral in gold.



Human beings always appreciate a narrative. They always try to explain what is happening around them based on previous experiences and surrounding events. However, especially in financial markets, the past is not always indicative of the future, or the present for that matter.

Many commentators have been scratching their heads at the market action last week, considering the economic data released in the US in particular. On Thursday, the Bureau of Labor Statistics released their preliminary consumer price index data for May, which showed a 5% year-on-year increase, the highest such print since August, 2008.

Such a high inflation print would normally push Treasury yields higher, but the opposite happened. The yield on the 10-year US Treasury fell 5.9 basis points on the same day, capping a 10.2 basis points drop for the week, the biggest weekly drop since the last trading week of March.

There are a few narratives that could explain the move, though. Two weeks ago, reports indicated that there were huge outstanding short positions in 10-year Treasuries. Such big positions could easily have been pushed into liquidation with the recent rally in Treasuries, which then accelerated the rally in the bonds, a classic ‘short-squeeze’.

The size of daily moves last week could justify this narrative. Three days saw 10-year Treasury prices rise by more than one standard deviation (using 2021 data). The squeeze could have started on June 4th, when there was a two-standard deviation rise in 10-year Treasury prices.

Some economists may use the latest US CPI to say the recovery momentum is slowing

The other narrative may refer to the fact that bond investors are often trying to discount the future of the economy, and the US recovery may have passed its peak in terms of acceleration.

Again, that narrative could be justified by the economic data last week. While the year-on-year print for inflation was very high, the month-on-month print dropped to 0.6% in May, compared to 0.8% in April. This deceleration in price increases could also signal that economic momentum is slowing as the reopening becomes more widespread.

There is further support for that argument in the base effect, the difference between the CPI index in May last year, when it had dropped sharply, and this year, when it had accelerated. The point here is that, in a year, the May, 2022, CPI will be compared to an index that rose faster than average for most of this year and, hence, is likely to show a figure that may be well below the 2% because of the same base effect that partly caused the 5% year-on-year print last week.

Hence, for people buying 10-year US Treasuries today, they could be looking at where they think inflation will be a year from now and how that would impact bond prices and, therefore, they may be willing to get a lower yield for the safety of US government debt. Plus, on a relative basis 10-year US Treasuries continue to offer excess returns compared to Europe and Japan. This relative value may be yet another potential narrative to explain the rally in Treasuries last week.

On Thursday, the European Central Bank's Governing Council said that bond buying under the Pandemic Emergency Purchase Program would be conducted at a "significantly higher pace" in the coming months. This commitment to even more liquidity during the summer helped to push the value of the euro down by 0.5% against the US dollar on Friday.

Conversely, the US Dollar index rose 0.53% on Friday, buoyed not only by the euro, but also other currencies, such as the British pound, which fell 0.49%, or the Japanese yen, which dropped about 0.3% on Friday alone. If flows continue to go stateside, the dollar could continue to gain.

While all of these narratives could help explain why major government bonds and currencies moved the way they did last week, financial markets are also random, and sometimes no narrative can fully explain their movement.

Investors, however, may have a chance to try and confirm if any of these narratives were really behind the moves seen last week starting this Wednesday, as the Federal Reserve concludes its rate-setting meeting. The economic numbers, along with the recent statements from several governors suggest there is a significant chance that the central bank will introduce the possibility that in a few months it may reduce the rate at which it increases its balance sheet, and therefore limit the additional new liquidity of dollars in the world.

If the Fed does signal it will begin to taper its asset purchases, some of the narratives above could start to unfold in a different manner. For instance, if there is any indication that the Fed sees the economic recovery remaining strong, the argument suggesting bond investors are bracing for a slowdown would lose luster. This, in turn, could prompt some selling of Treasuries, particularly long-dated ones.

Similarly, if the driver has been too many short positions in long-dated US Treasuries, then the Fed's confirmation of the rationale which probably drove these positions to be created could prompt some investors to rebuild the shorts. That, in its turn, could also push Treasury yields higher.

Finally, if the explanation is more related to the value of Treasuries compared to other major government bonds, particularly European, then a signal by the Fed that it will slow down additional liquidity should help Treasury yields drop further and potentially further strengthen the US dollar. If the narratives above are all wrong, then commentators will continue to scramble for explanations for market moves this coming week.

Regardless of explanations, however, investors will be keenly watching the Fed's decision this Wednesday given the importance the US Treasury market has had lately on other financial markets. The shares of big technology companies, for instance, have been very sensitive to moves in the 10-year US Treasury yield, which has not always been the norm.

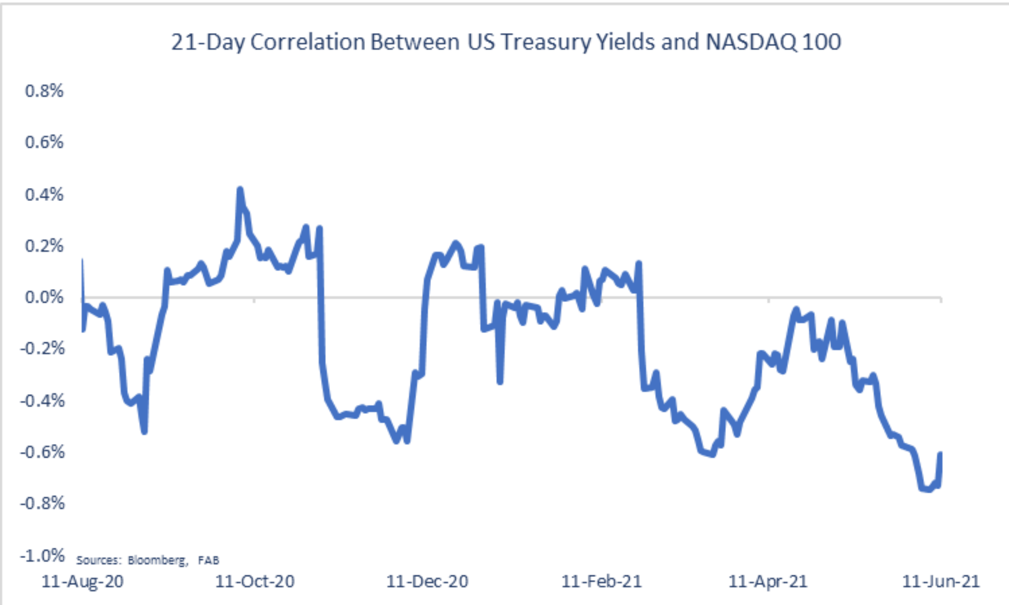
Indeed, the NASDAQ 100 index rose 1.65% last week, just as the 10-year US Treasury yield dropped by more than 10 basis points, as noted above. Similarly, the Japanese stock market has been in the doldrums so far this month, and is down 3.03% since the start of the second quarter, while Treasuries have been rallying. This could be partly explained by Japanese banks (which are important investors in the local stock market) finding they could get steadier and less volatile returns by borrowing in yen and buying US Treasuries than in putting a lot of money into Japanese shares.

All this suggests a lot of investor anxiety about the wording of the Fed's statement this week. Setting aside these short-term dynamics around this meeting, the overall economic and financial picture is hardly nail-biting.

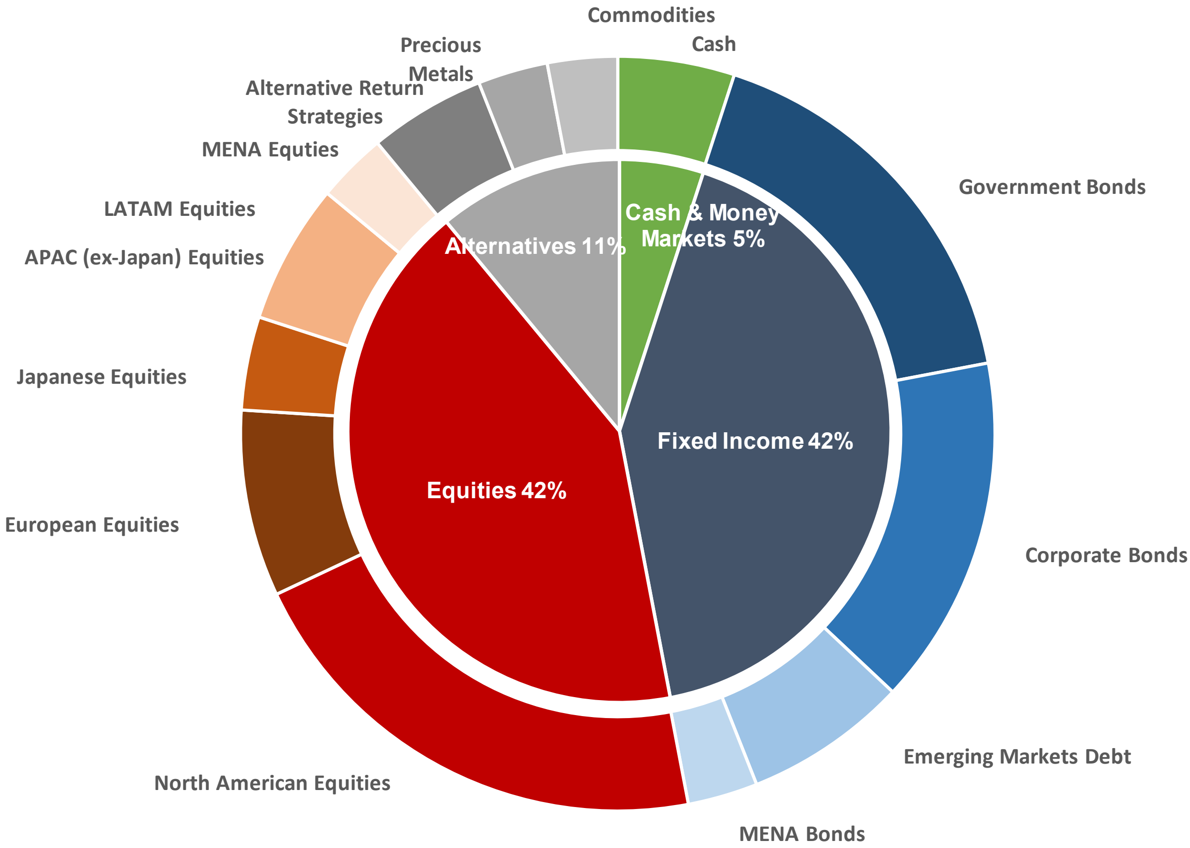
The one thing investors can be sure of is that the Fed will signal that the US economy is recovering well, as is the rest of the world. It will also reiterate that it plans to keep monetary conditions very easy for the foreseeable future as it tries to bring unemployment in the US back to 4% or below.

This is the definition of a Goldilocks market, when rates are unlikely to pose a hurdle for a while even as the economy, and company profitability is likely to continue to rise. It is the perfect environment to continue to invest in risk assets, and that is what savvy investors are likely to continue to do.

Shares of big technology companies have continued to move along with Treasuries



Asset Class	Positioning	Detail
Cash	Underweight	Putting cash to work in risk assets.
Fixed Income	Overweight	Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds
Equities	Overweight	Slightly overweight in Asia ex-Japan and US markets.
Alternatives	Underweight	However, reducing the underweight in hedge funds



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