Investment Weekly

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Rising 10-year US Treasury yield could offer opportunities

♦ April and May could see a spike in year-on-year inflation in the US due to a drop in consumer prices last year.

♦ The yield on the 10-year US Treasury tends to follow year-on-year CPI, so it could move even higher in the coming weeks before stabilizing later this year.

♦ US Fed Chairman Jerome Powell and Secretary of Treasury Janet Yellen are set to testify in Congress this week and could temper some of the volatility.

♦ Any sell-off, however, may be an opportunity, as risk assets are still likely to offer positive returns in 2021.

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

Treasury auctions are usually non-events. The most liquid market in the world sees them regularly and hardly a word is uttered about it. That changed a month ago, when a poorly attended sale of seven -year notes accelerated a sell-off in US government bonds, particularly those with longer-dated maturities.

The Bloomberg Barclays US Treasury Long index, which measures the return of US government bonds maturing in 10 years or more, has fallen 20.2% since 4 August, its recent peak. The index has fallen every week since end-January and is down 10.9% in the past seven weeks.

The drop accelerated after the seven-year auction. Which is why investors are watching the large Treasury auctions set for this week. How well they do could determine the direction of bond markets in the coming weeks.

The US Treasury is set to auction some US$62 billion in two- and seven-year bonds this week. Ahead of the issuance, the yield on the 10-year US Treasury rose to 1.72% on Friday, its highest since January, 2020. Last week alone, the yield on the benchmark increased by nearly 10 basis points, with nearly 80% of the move happening on Thursday and Friday.

Part of the reason why long-dated US Treasury yields rose so much towards the end of the week was a decision by the Federal Reserve not to extend supplementary leverage ratio exemptions for US banks. The measure was implemented a year ago to reduce the pressure on lenders and allowed them to hold more long-dated US Treasuries.

The amount of Treasuries expected to be unloaded as a result of the return of the supplementary leverage ratio is not so significant compared to the overall size of the market. However, the selling comes as Treasuries are already out of favour.

An index of US Treasuries maturing in 10 years or more has fallen 20% since August

As the various fiscal stimulus packages continue to be rolled out, investors have become increasingly concerned about the prospects of inflation in the future. As a result, they are seeking higher yields from US Treasuries to compensate them for the potential loss of purchasing power that their cash can suffer over time.

The yield on 10-year US Treasuries has a significant correlation with the current value of year-on-year inflation. With that in mind, the outlook for consumer price increases in the next couple of months suggests Treasury yields could move even higher from here. In April, 2020, the CPI index fell 0.7% to 256.39 and stayed there in May. The latest reading on the price index was 263.014, and the current trend suggests it could reach 264 by May.

If that occurs, the year-on-year inflation reading would be around 3% in April and as high as 3.3% in May. The index trend suggests the move will be temporary and inflation is likely to move back below 2% around the end of the third quarter.

However, the sticker shock of the sudden rise and the close correlation of Treasuries with current inflation suggest that bond bears could have a field trip in the next two months. As the yield on the global rates benchmark increases, values of all other assets could be impacted as well.

Growth stocks and investment grade bonds, as well as gold, are particularly sensitive to moves in the long-term yields in US dollars. This has already been in evidence as the NASDAQ 100 has fallen in four of the past five weeks and is down 6.81% since its recent peak on 12 February. Gold prices, in their turn, are down 8.1% since the year began.

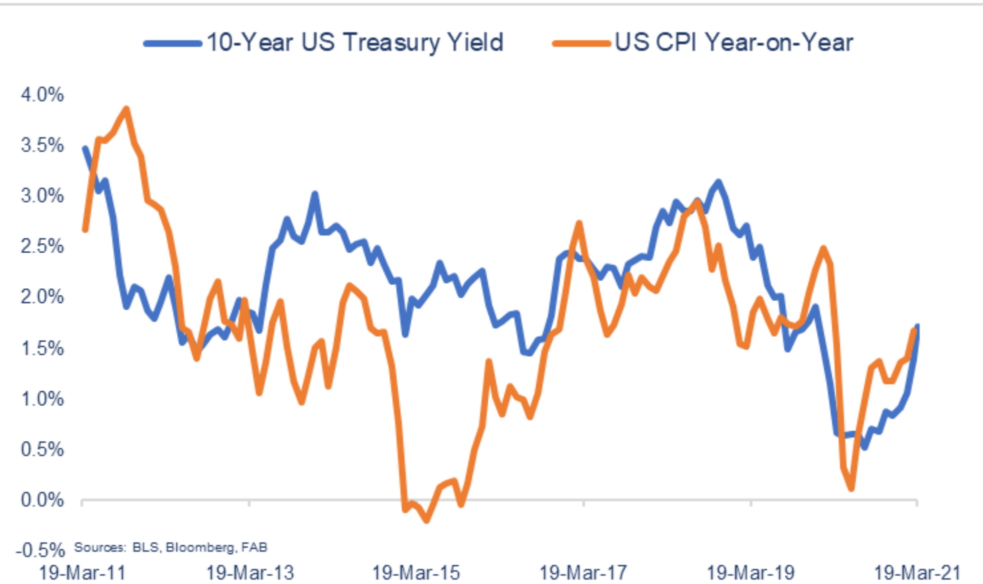
These assets have one thing in common: they pay very little or no regular income. Hence, when investors see that they can earn a decent return for owning long-dated Treasuries, which are generally considered the safest asset, they start to require a better price to show interest for investment grade bonds, growth stocks (which often pay no dividends) and gold.

As a result, if yields on long-dated Treasury yields rise in line with inflation in the next couple of months, some of these assets may drop further, and, in fact, reach attractive levels. The still high level of unemployment across the world, however, suggests a rise in inflation may be short-lived. The US economy is still running at least US$1 trillion behind its GDP potential, which means it needs to grow a lot simply to go back to its normal pace.

More importantly, the Federal Reserve indicated in its latest summary of economic projections that the US will have reached maximum employment (one of the Fed's goals) when the unemployment rate is at 4%. The median forecast among Fed economists is that this will be reached sometime next year, and that this year will end with unemployment around 4.5%.

Fed economists and US Secretary of Treasury Janet Yellen, though, have paid more attention to total employment, the number of people of working age with a job. This is different from the headline unemployment, which excludes people who have given up looking for a job.

The yield on 10-year US Treasuries tends to move in line with year-on-year inflation



Sources: BLS, Bloomberg, FAB

That number remains very high. At the end of February, 2020, 153 million Americans had jobs. Even after a record recovery, only 143 million people are currently employed in the US. In the past six months, the US has created about 316,500 jobs a month. While that could accelerate, even at 500,000 a month it could take some 20 months before the 10 million lost positions are reinstated.

Both Mdm. Yellen and Jerome Powell, the Chairman of the Federal Reserve, are likely to allude to that fact in testimony to lawmakers in Washington DC on Tuesday and Wednesday. This reminder may help assuage some fears that could stem from a packed Treasury issuance calendar and from higher inflation rates ahead.

This is also the reason why it may be premature for investors to assume that the inflation numbers — and accompanying high yields on longer-dated US Treasuries — that could surface in the next two months will be the new norm. With so many people unemployed, it is just a matter of time before the rising consumer prices start to slow down.

Nonetheless (with the possible exception of the days when Mdm. Yellen and Mr. Powell are speaking) this week and the coming month are likely to see heightened volatility, particularly for the growth stocks with the most extended valuations.

Given that the expectation, however, is still for inflation to drop back to its long-term average later this year from the temporary April and May bump, such volatility may be an opportunity to acquire some high-quality assets at cheaper prices.

While the numbers coming may cause the market to wobble, it is likely that by year-end Treasury yields will have retreated from the potential second quarter highs, This could come at the same time as the US is experiencing very healthy growth. Such a Goldilocks scenario could help risk assets perform very well into the end of the year, and mean any short-term volatility could be seen as opportunity.

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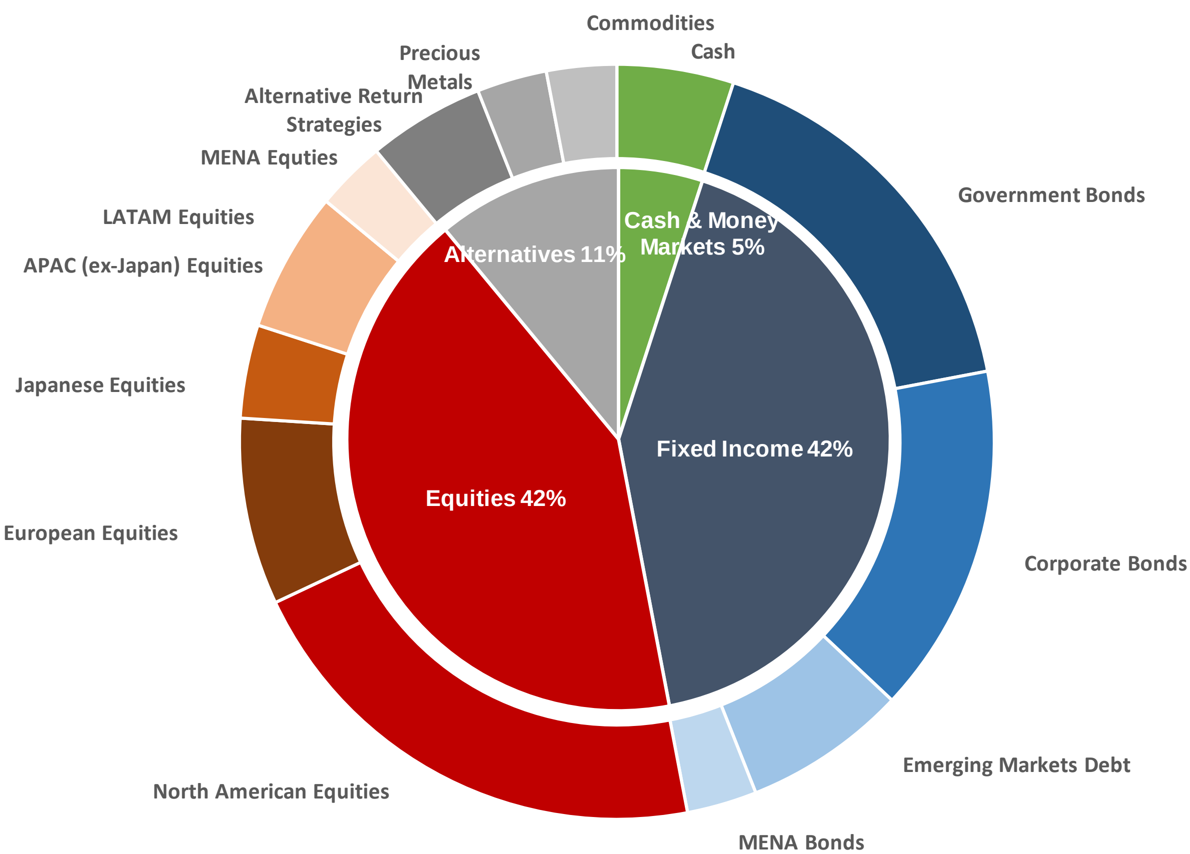
Current Tactical Asset Allocation



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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