INVESTMENT STRATEGY WEEKLY VIEW

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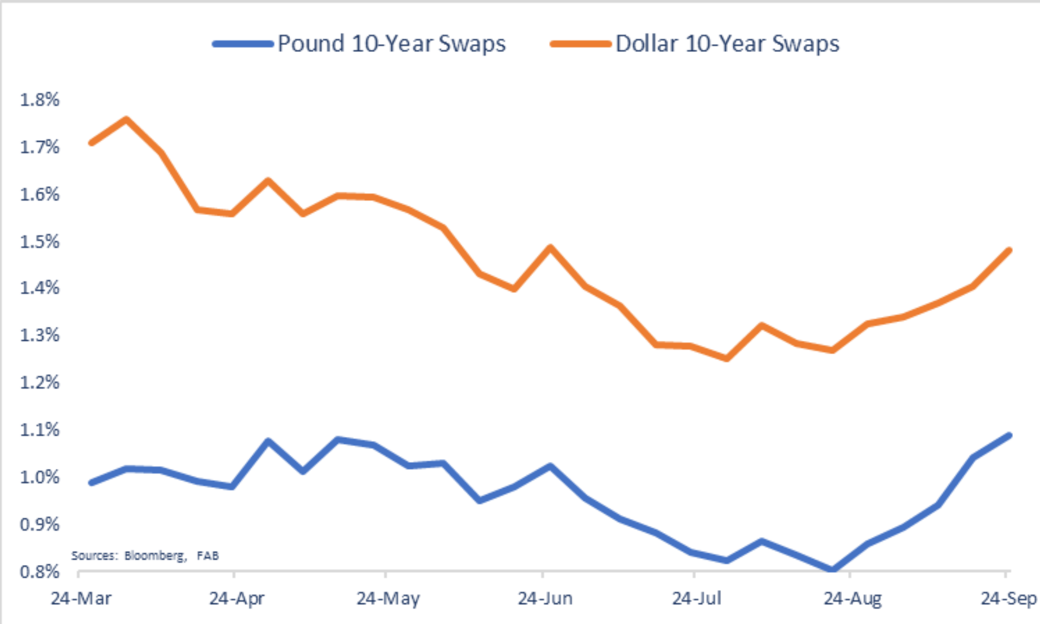
YIELDS ARE RISING ACROSS THE GLOBE

September 26th 2021

- The Federal Reserve said it may start to taper its asset purchases as soon as the November meeting.
- FOMC members suggested they should end asset purchases by mid-2022.
- The Bank of England has opened the door to increasing rates later this year, helping to push yields higher across the globe.
- The FAB AAC is overweight in equities, IG and EM bonds. It is underweight in cash and neutral in gold.



"If (US economic) progress continues broadly as expected, the Committee judges that a moderation in the pace of asset purchases may soon be warranted." These words in the latest Federal Open Market Committee meeting statement turned heads last week, particularly the word 'soon'. It was seen as a confirmation of what many already expected: that the Fed would start tapering its asset purchases as early as November.

In his press conference last week, Fed Chairman Jerome Powell went further and said clearly that this wording was meant to warn the market that the 'taper' could start as early as their next meeting, in November, as long as the US economy continues to recover at the current pace.

Curiously, the yield on the 10-year US Treasury dropped two basis points that day. It seemed as though investors were more concerned about the significant downgrade to this year's growth that Fed officials made in their summary of economic projections.

While in June the median estimate among contributing members of the Fed was for the US economy to grow by 7% this year, the latest set of forecasts see it expanding by 5.9% this year. The central bank's economists have upgraded their median expectation for next year's expansion to 3.8% from 3.3%, however, although the economic path is becoming more uncertain amid rising Covid cases.

The path of interest rates also shifted in the latest set of economic projections, with nine out of 18 contributors seeing rates rising as early as next year.

British pound interest rates have spiked and are helping push Treasury yields higher

The reaction in the bond market on the day of the Fed statement, however, suggests investors are skeptical about this scenario. The Fed's rate path is dependent on employment, inflation, and growth rates, and while these seem to be on course to allow for a 'lift-off' in the Fed funds rate as early as next year, there is much that could yet shift that timeline.

In fact, Chairman Jerome Powell himself suggested that inflation had already exceeded their target but that employment still had some way to go to reach their target, and that the spread of the Delta variant of Covid-19 had raised questions about economic growth in the short-term.

The fact that the two-year Treasury yield rose by 2 basis points, while the 10-year retreated, suggested investors were predicting that the early reduction in monetary accommodation could slow down future growth and hamper the Fed's ability to increase rates in the future. Furthermore, while the Fed's 'dot plot' now shows a likely rate hike as early as next year, Fed fund futures, which reflect market-based expectations, barely moved after the Fed meeting.

This could mean that the market sees more economic risks ahead than the Fed seems to assume, and is therefore questioning the rate hike timeline. Bond markets, however, are globally connected, and while they may have sent that message on Wednesday, after the Fed meeting, the next day the narrative changed.

On Thursday, the yield on the 10-year US Treasury spiked 13 basis points, its biggest jump since late February. The move followed a similar jump in the yield on 10-year British pound swaps, with the latter prompted by a more hawkish than expected Bank of England. It seems that, as investors considered a higher probability of UK rates rising as early as this year, they also began to shift money around from the key global bond markets.

The Treasury market was not the only one to react to the Bank of England. The 10-year German Bund yield rose six basis points, while the Japanese government bond due in 2031 saw its yield rise by two basis points. This move away from US Treasuries into other bond markets at a time when the biggest single buyer of Treasuries is expected to reduce its own purchases could prompt a further rise in Treasury yields.

If that does happen, it may shift the opportunity set within global bond markets. The ultra-low interest rates in the US, as well as the growing participation of the Fed in the Treasury market, has been pushing investors towards weaker credits at an unprecedented rate, and that dynamic could shift.

The yield premium on the Bloomberg US Corporate High-Yield index fell to a record low of 262 basis points in early July, almost 40 basis points below its previous record of 303 basis points, touched in late 2018. While the investment-grade bond space has also seen record low yields, the move has been particularly sharp amid junk bonds.

For instance, the premium of the same high-yield index over an index of BBB-rated US bonds also fell to a record low of 166 basis points two weeks ago. This could be an unintended consequence of the lack of super-safe bonds available, given the weight of the Fed in the Treasury and mortgage-backed securities markets. As that weight diminishes, the safer bonds could become relatively more attractive.

This is another way of saying that the high-yield market may be particularly vulnerable to rising US Treasury yields. One way of looking at it is that if high-yield has outperformed when yields were dropping, it is likely to underperform as they rise.

The high-yield market, however, is not a single block, and some parts of it are likely to perform better than others. Asian high-yield bonds, for instance, have as a class been so pressured by concerns around Evergrande that they are could outperform their US and European counterparts in the coming months.

There is still room for further volatility in Chinese assets, given the risks of more negative headlines, particularly in relation to the restructuring of the world's largest developer, Evergrande. However, the People's Bank of China has started to shore-up the financial system, and last week alone injected close to 150 billion yuan (US$23.2 billion) of liquidity, both through reverse repos and open-market operations.

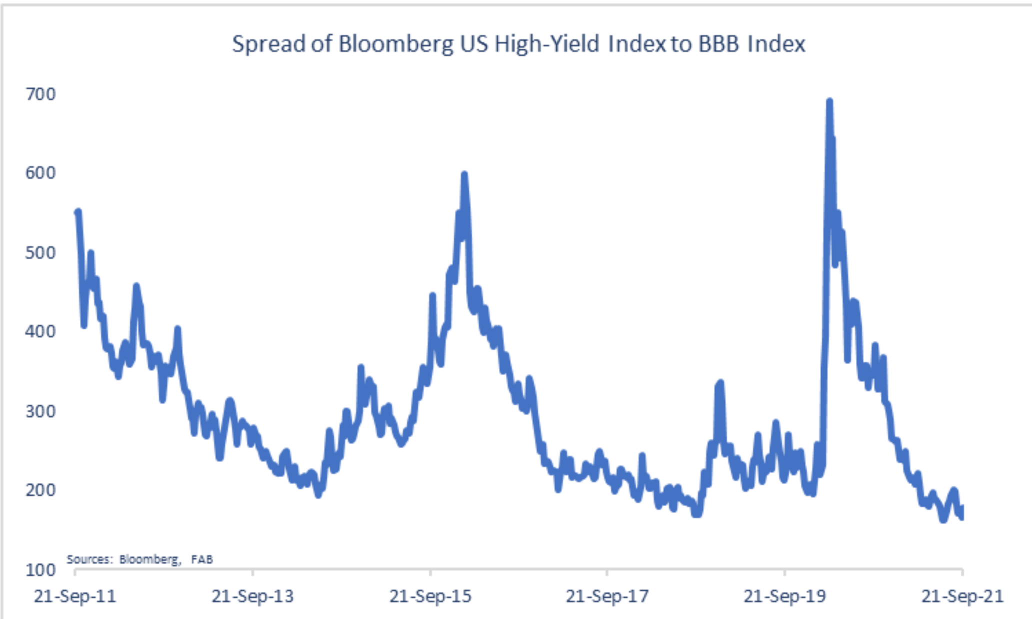
There is a chance that China also reduces the required reserve ratio for its major banks in the coming days, in a bid to add even more liquidity. It has the room to do so, given that the Chinese economy has slowed down markedly in the past couple of months. The latest evidence of that came in the form of a negative surprise in retail sales last week.

Investors will this week get a glimpse of whether the Chinese economy has continued to slow down, or if it is starting to recover, when the country's purchasing manager surveys, the PMIs, are unveiled. The last private measure of purchasing interest (an important indicator of future potential growth) came in below the 50 level, indicating that the country's economy was shrinking.

The yuan is also strong. The CFETS index, which measures the currency's strength, relative to those of a basket of China's major trade counterparts, was at 99.02, its highest since early 2016, something that may reduce domestic economic growth.

If China loosens monetary (and maybe also fiscal) policy, it could be a welcome counterbalance to the UK and the US, where policy is gradually becoming less accommodative. While the world has probably recovered from the worst of the pandemic, the Delta and other variants are still causing sufficient uncertainty that growth remains below potential.

Yield premiums of junk bonds over higher quality debt have been at record lows



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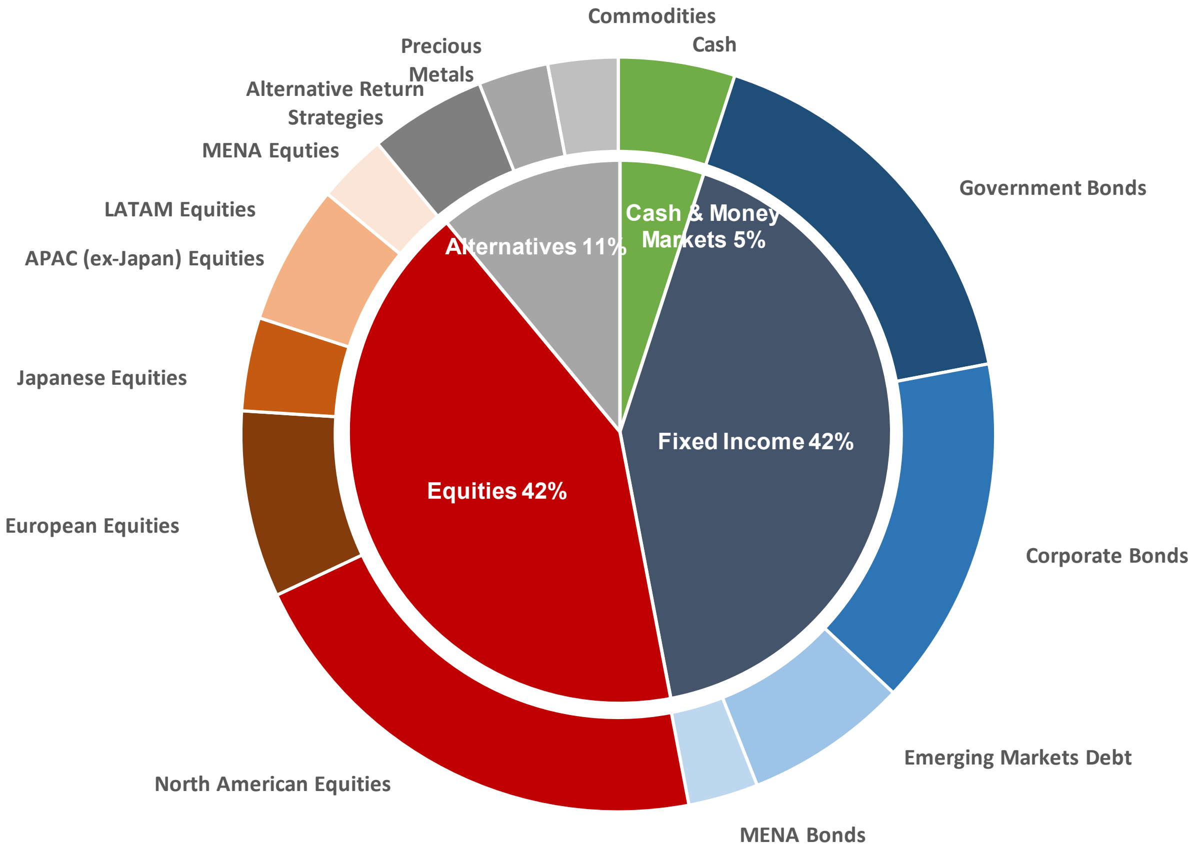
Asset Class	Positioning	Detail
Cash	Underweight	Putting cash to work in risk assets.
Fixed Income	Overweight	Keeping a slight overweight focused on EM dollar debt and on corporate investment grade bonds
Equities	Overweight	Slightly overweight in Asia ex-Japan and US markets.
Alternatives	Underweight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



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