Investment Strategy Update

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21 October, 2020

The bond market seems convinced that stimulus is coming

♦ The yield on the 10-year US Treasury breached 0.8% today, the first time it has done so since early June.

♦ The benchmark has been stuck in a range between 0.9% and 0.5% since late March.

♦ The yield difference between the 30-year and the five-year bonds has also increased to 126 basis points, the highest since 2016.

♦ The moves signal that bond investors are starting to see the prospects of steeper inflation ahead.

♦ This may imply a higher probability of fiscal stimulus is starting to be priced into Treasury yields.

♦ The FAB AAC remains slightly underweight in equities, and overweight in IG bonds and gold

Bond investors are often seen as more prescient in their decisions than stock buyers. It could stem from the fact that buying bonds requires larger investments and therefore usually involves more sophisticated people. Whatever the reason, people tend to pay attention when bond markets move.

They have been doing just that in the past week and today the 10-year US Treasury yield breached 0.8% for the first time since early June. The yield difference between 30-year and five-year US Treasuries became higher than 126 basis points, the first time it has done so in four years. It may not be entirely a coincidence that the previous instance when long bonds were paying so much more than short ones was just before the last US election.

With the benefit of hindsight, the bond market could have been discounting a higher probability of a Donald Trump win than polls suggested at the time. The then -candidate was running on a platform of tax cuts and larger deficits, both of which should translate into higher inflation and, consequently, yields.

If that theory is correct, perhaps the bond market is seeing a blue sweep right now. While the Republican-controlled Senate and the White House have been reluctant to increase spending much, the mostly Democratic House of Representatives and Vice-President Joe Biden have been advocating for a lot fiscal stimulus.

It may be premature to read a judgment of the election outcome in the bond market's recent move, though. Perhaps, the message is, instead, that whoever wins will have to push for more fiscal stimulus as a second wave of Covid-19 infections stalls the nascent economic recovery. And that would mean inflation in the long run.

The yield on the 10-year US Treasury broke through 0.8% and the curve steepened today

The fact to keep in mind, however, is that yields are unlikely to move much higher from here. The Federal Reserve is committed to keeping interest rates low and could intervene if they rise too far. Besides, higher Treasury yields attract foreign investors, who can then borrow in negative-yielding currencies and earn better returns in dollars.

Hence, whenever 10-year US Treasury yields start to approach 1%, investors should consider looking at opportunities to add investment-grade bonds to their portfolios. With unemployment likely to remain high for a few years, benchmark rates will probably remain low, which means investors have to take any opportunity they are given to achieve higher returns at a relatively low risk.

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