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Macro & Markets: Will this time be different?

Marketing communication

Macro & Markets Strategy

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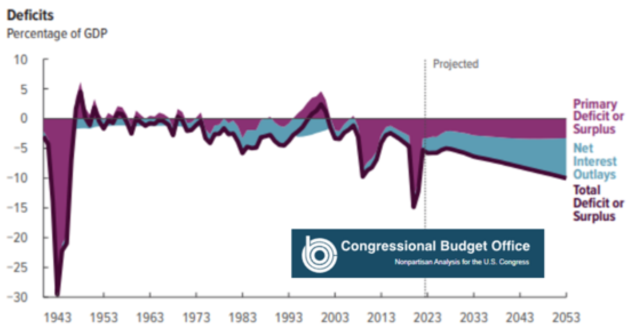
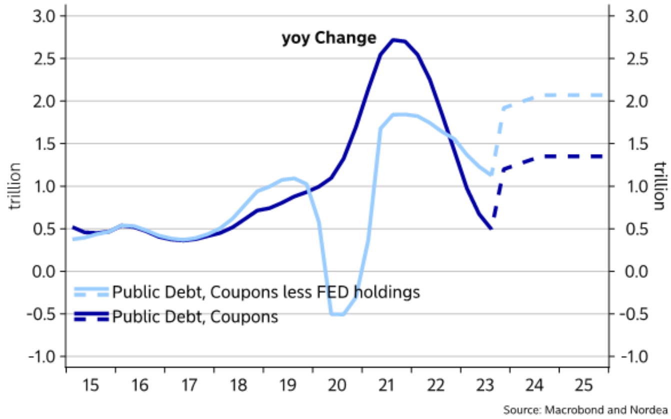
In a hiking cycle, the 10Y rate usually keeps rising to at least match the peak in the fed funds rate. Increasing bond supply, a strong equity market, a less rate sensitive economy and high inflation are all reasons to expect a repeat

Interest rates have staged an impressive rally this year with 10Y US treasury rate up 150bp since the lows in April. Even with inflation cooling off, better economic data, a smaller impact from the regional banking crisis and increased focus on the US budget deficits has led the market to price out rapid rate cuts and increased the term premia on longer dated bonds. At close to 4.75%, 10Y rates are somewhat higher than out long run estimate for neutral, which we see at equal to nominal trend growth at about 4%. But, given that inflation is still much higher than the 2% target, it is not surprising and perhaps needed to have a clearly restrictive level of rates.

A significant part of the bond sell-off since summer can probably be attributed to the increased focus on the large funding needs of the US government. The June 28th revised estimates from the Congressional Budget Office indicates a steadily growing deficit where interest payments makes up an increasingly growing share. With the Fed winding down its portfolio, the US Treasury will probably have to rely on investors to increase their bond holdings by 2th/year, twice the 2019 pace. To either attract new investors or entice existing holders to increase their allocation, interest rates need to be attractive.

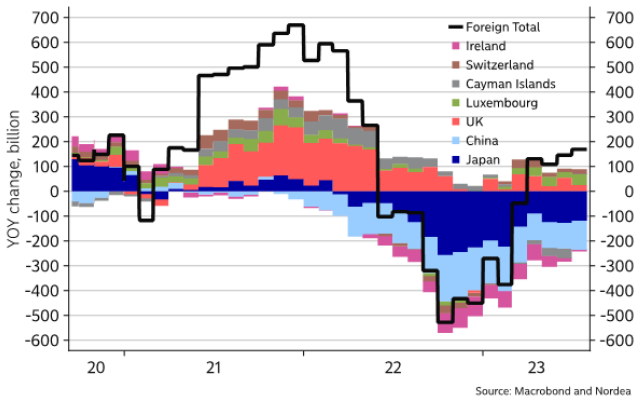
Chart 1: Higher deficits and Fed QT means investors must fund 2tn of new UST bonds every year going forward

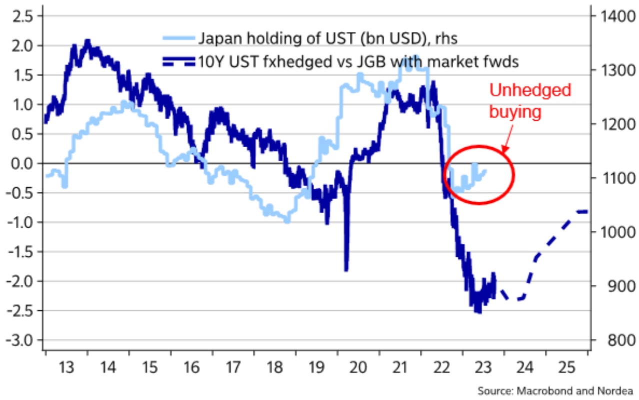




After having increased their UST holdings at a rapid pace until 2014, foreign investors have been net sellers since 2021. While some of the change can probably be attributed to politics, the economics of buying longer dated US Treasuries on an fx-hedged basis turned very sour when the Fed hiked rates and the curve flattened massively up until the summer. Japanese investors sold more than 200bn of USTs last year, but have been small net buyers this year. A large share of the renewed buying is without fx hedging according to comments from several Japanese L&P companies. For foreign investors to markedly increase their allocation to USTs, we would probably need to see the curve steepen further, perhaps into positive territory from 3M and out.

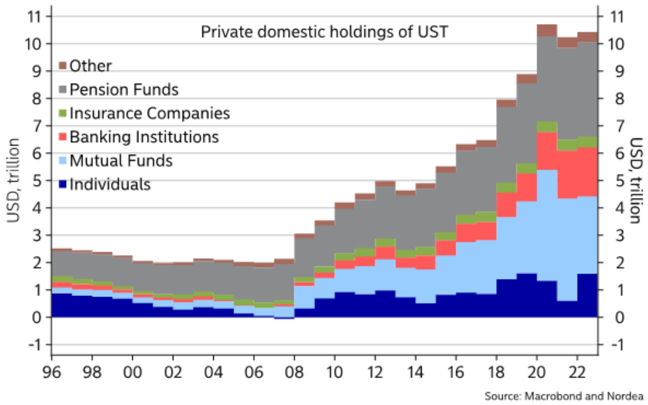
Chart 2: Foreign investors have been selling USTs since 2021 as an inverted yield curve have turned carry deeply negative.

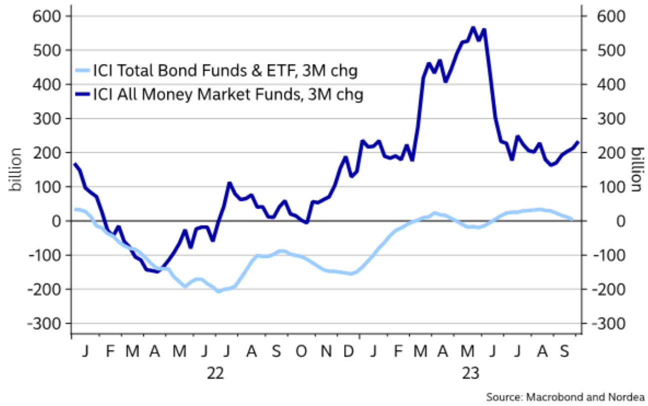




Private domestic investors were large buyers of USTs during the pandemic, but that looks to be changing. The bond selloff last year left many banks heavily hit by mark-to-market losses in their (assumed) hold-to-maturity portfolios and led to several bank failures this spring. Silicon Valley Bank being the most spectacular. Banks are now understandably less eager to increase their UST holdings. Mutual bond funds were popular in 2018 and 19, but over the last 2 years, money has been flowing out of bond funds while Money market funds (at higher interest rates), have been far more popular attracting huge inflows.

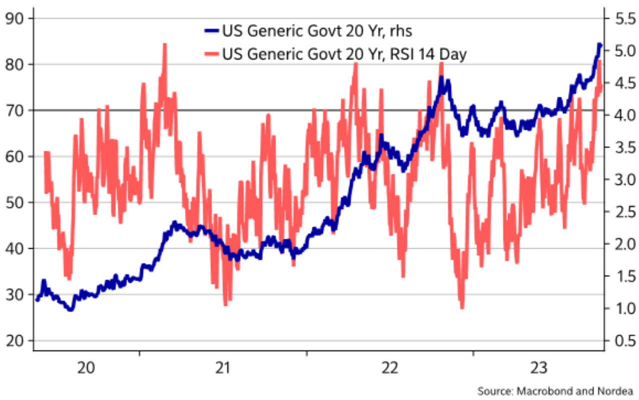
Chart 3: Banks will not continue to be a large sponsor of UST, and money markets fund are far more popular than bond funds.

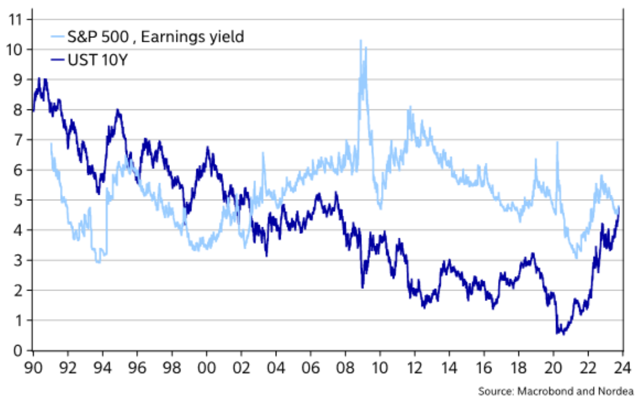




Rates have increased rapidly over the last couple of weeks, and techincal indictors, like the RSI, suggests deeply overbought levels. The speed of the selloff indicates that a large number of investors have taken a stop-loss on their long bond holding and that the fast-money community is now positioned for higher rates. With stop-loss activity coming to a halt and with profit taking on short bond positions, It would not be surprising if rates were to correct lower by 20-30 bps in the short run. However, to really attract large investments, we will probably need to see investors lose their faith in the equity market and to allocate their funds into the bond market. With S&P500 earnings yield almost at par with 10Y treasury rates, we could see why this could happen, but so far the equity market has been very resilient.

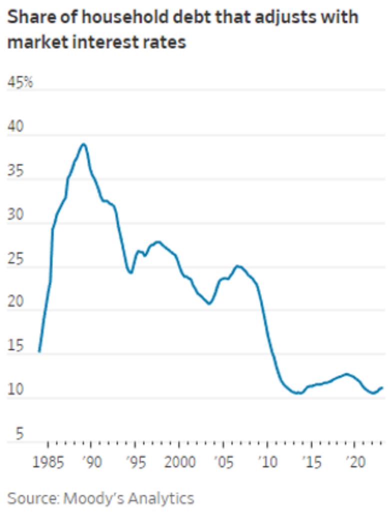
Chart 4: Bond rates looks overbought and will probably correct lower, but the big swing will probably not come before investors give up on equities

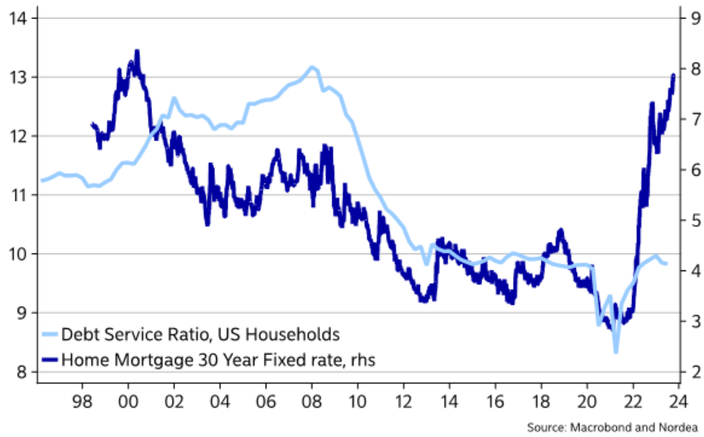




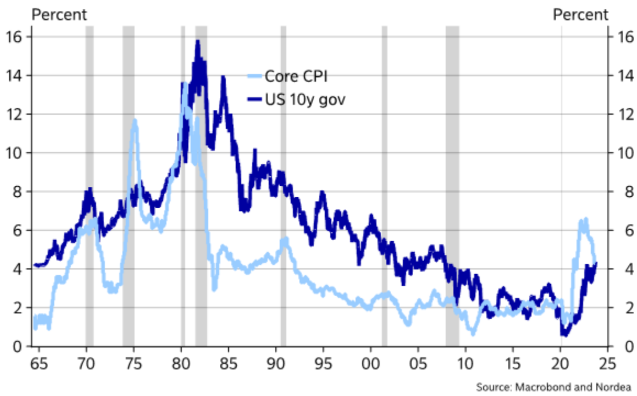
Bond rates are very much a relative play along the curve, and should the outlook shift to rapid rate cuts by the Fed, the current levels of bond rates would look very attractive. Higher bond rates in itself will probably also lead to lower economic activity and for the Fed to loosen policy, but so far, the economy has been very resilient. New mortgage rates have climbed by more than 5% to surpass 8%, but still debt serivce costs for US households have barely bulged. With a much lower share of household debt on floating rates, it will take a long time for these rate increases to eat into consumers wallet books.

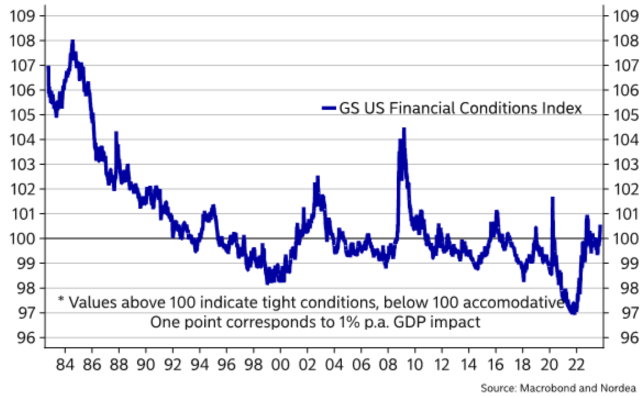
Chart 5: With a 90 pst of household debt on (low) fixed rates, it will take a long time before the current higher mortgage rates really impacts consumer spending power





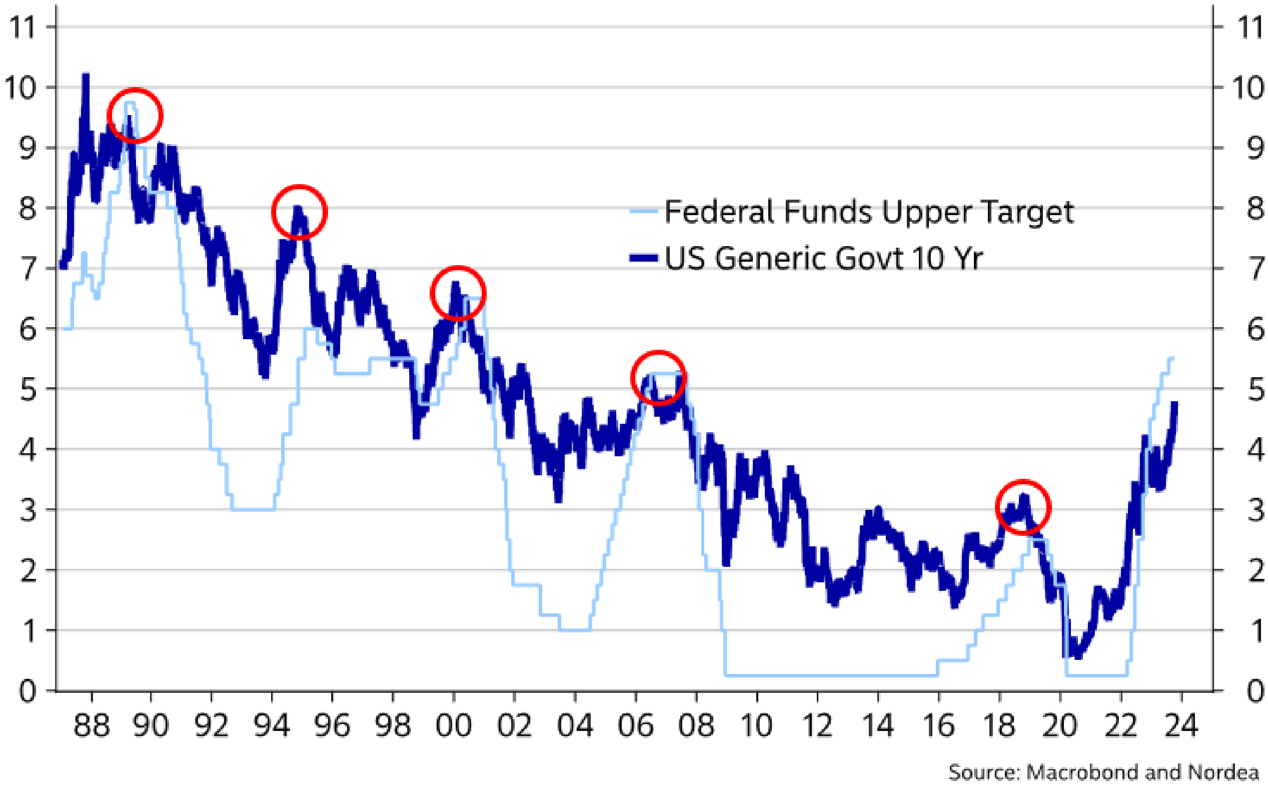
High inflation and rapid wage growth means that the current nominal levels of rates are less restrictive. Previous recessions have occured when the real 10Y rate (vs current core CPI) has exceeded 2%. Currently, real rates are only marginally above zero. Solid corporate earnings have kept the equity market aloft and credit spreads low, and so far US financial conditions are only barely into restrictive territory. Perhaps it is not so surprising that the US economy is still humming along just fine?





Looking back at previous Fed hiking cycles, 10Y treasury rates have always kept rising to at least match the peak of the fed funds rate. A non-inverted curve would lead more domestic investors out the curve and make buying USTs on an fx-hedged basis for foreign investors attractive again. Perhaps this time will not be that different after all?

Chart 7: The 10Y rate usually matches the Fed funds peak of each hiking cycle



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