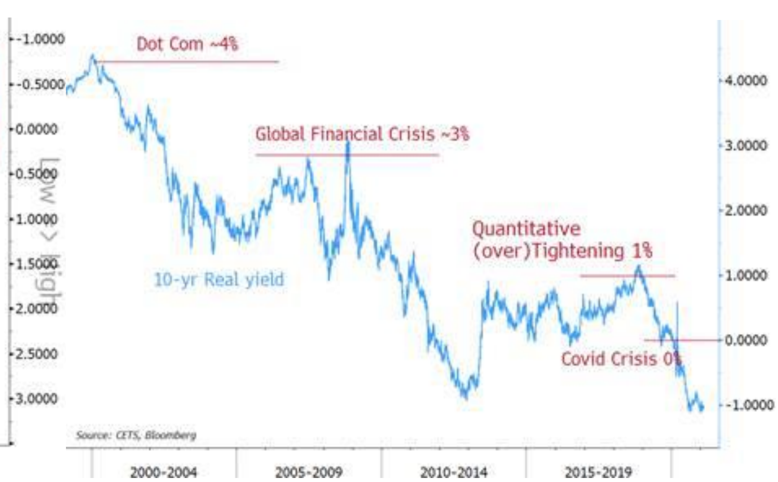
I covered a piece back in early January looking at what equities did the last time we saw a meaningful rise in UST yields, and perhaps more importantly, which sectors performed the best (see [What did equities do around the taper tantrum?]). The key conclusion was investors need to aggressively shift not only into pro-cyclical parts of the market, but crucially into *commodities* that have the highest beta to rising yields**. This was in turn part of the reason why CETS broadened their [bullish Energy thesis] from last year into a 'buy all commodities' narrative (see [Scarcity value in a commoditised world]). Conviction here remains extremely high.**

		Dividend Yield				FCF Yield		Sensitivity to 10yr	
Ticker	Sector	12 m	rank	estimated	rank	12 m	rank	beta	rank
S5ENRS Index	S&P 500 ENERGY INDEX	5.29	1	5.19	1	0.73	9.00	7.59	1
S5UTIL Index	S&P 500 UTILITIES INDEX	3.41	2	3.46	2	-3.68	10.00	-4.24	10
S5RLST Index	S&P 500 REAL ESTATE IDX	2.91	4	2.98	3	0.81	8.00	-3.53	9
S5CONS Index	S&P 500 CONS STAPLES IDX	2.93	3	2.84	4	5.13	2.00	-5.35	11
S5FINL Index	S&P 500 FINANCIALS INDEX	2.07	5	2.02	5	N/A	N/A	6.93	2
S5MATR Index	S&P 500 MATERIALS INDEX	1.83	6	2.00	6	4.55	3.00	2.02	4
S5HLTH Index	S&P 500 HEALTH CARE IDX	1.57	8	1.69	7	5.15	1.00	-3.50	8
S5INDU Index	S&P 500 INDUSTRIALS IDX	1.59	7	1.60	8	2.41	7.00	2.48	3
S5TELS Index	S&P 500 COMM SVC	0.92	9	0.97	9	4.35	4.00	-2.63	7
S5INFT Index	S&P 500 INFO TECH INDEX	0.90	10	0.95	10	3.41	5.00	1.68	5
S5COND Index	S&P 500 CONS DISCRET IDX	0.60	11	0.72	11	2.82	6.00	-2.37	6

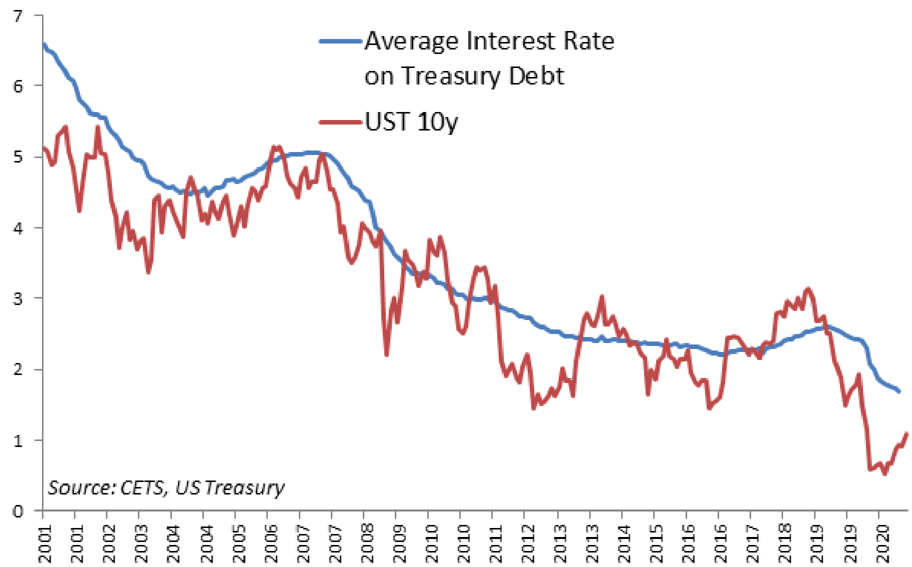
Source: Citi Equity Trading Strategy

However, the team has been receiving an increased amount of incoming over the past two weeks as to whether there is a definitive level of UST yields that should get them worried on broader equity risk, and the answer is 'yes'; **It's around 1.7% in 10s**. There are two approaches to getting to this level, one involving real yields and one involving nominal yields, which I will address in turn.

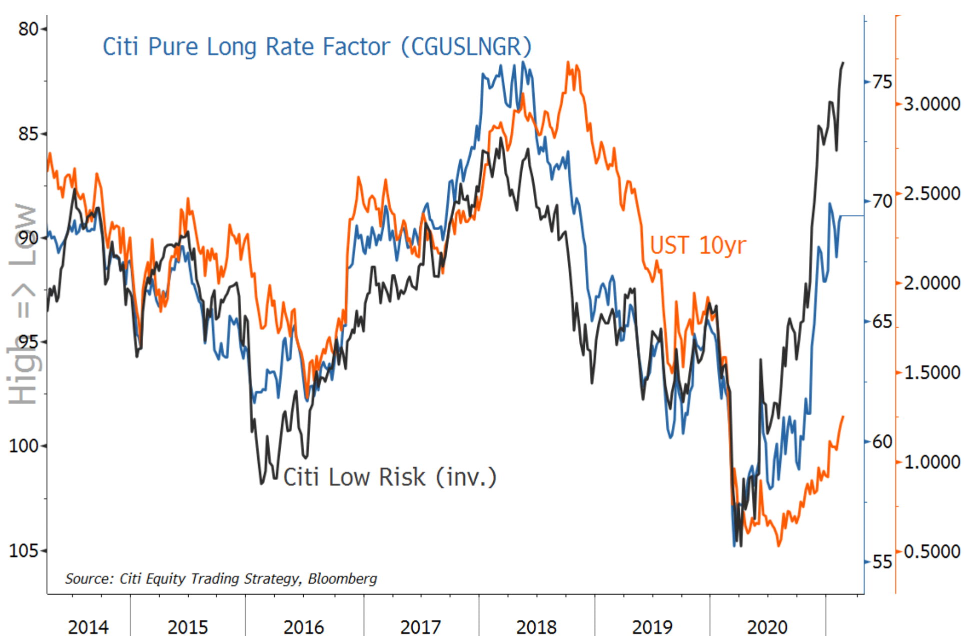
Real yields. I've looked at the impact on real yields and equities many times in the past (see [here], for example), and the easiest way to think about it is that they act as a 'brake' on valuation in our asset class: the relationship between real yields and P/E has been loosely negative over the past 20 years or so, with some dislocations emerging in the wake of the GFC (first chart). The 2018 Fed experiment of quantitative tightening was the perfect example to show what happens when central banks start to take too many Jenga blocks out the tower, real yields rise, and financial conditions turn into an acute case of indigestion for equities. Recall real yields were 'only' +100bps despite the economy growing at 3%, but each crisis we have witnessed since the 1990s has been associated with ever lower real yields (second chart), and has resulted in an environment where the current crisis unfolded during a negative real yield environment. Given the US (and most countries) has ballooned its debts even more during COVID-19, **there is zero tolerance for positive real yields for the foreseeable future**. In the same way that equities struggled during H1'18 as real yields rose from 50bps to 90bps, we should expect a similar pattern should real yields inch from -100bps up towards the zero bound - thus assuming a static 2.25% 10yr breakeven, the nominal yield 'biting point' would be 1.7% (i.e. a real yield above -50bps).



Nominal yield. Although I am personally of the belief that real yields have a stronger *direct* linkage to equity performance in the current environment, I appreciate that many investors will think about the world in asset allocation terms and thus nominal yields are obviously more relevant. There's little point using this column to start thinking about the carry profile of FX-hedged Treasury investments by, say, Japanese investors, but it is worth touching on the evolution of nominal yields post GFC and what level they were during periods of equity turbulence. The chart below illustrates the blended cost of debt for all Treasury instruments, and it is quite clear that since 2008 that any period of sustained market turbulence has been associated with nominal 10yr yields rising above the blended cost of debt. Although the relationship is not binary, nor immediate for that matter, it may help investors gauge another dimension of when equities may start to get uncomfortable with the level of interest rates. **Today the blended cost of debt at the Treasury sits at 1.7%**.



Our Rates team still have a 2021 UST forecast of 1.45% in 10s and 2% in 30s, but even they admit that there is room for overshoot by 25-30bps in their latest weekly piece (see **here**). If I look across the spectrum of our equity quant indices that track well historically against USTs, they're all saying the same thing to varying magnitudes; yields should be a *lot* higher. So for now, equities – especially cyclical ones – can enjoy the ride in yields creeping up, but watch out for pinch points ahead, as I suspect the path towards higher rates will not necessarily be plain sailing in calm seas.



If you think the path with high yields becomes more rocky along the way, then given equity/rate correlation is positive and trading equity down/yields up still makes a lot of sense. Our hybrids desk can show a number of different structures via contingent option and dual digital formats to reflect this – please reach out to your sales person for more details.

Alty

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All charts/data sourced from CETS, Bloomberg and Citi, unless otherwise indicated.