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Weekly Market Flash

How much will the Fed allow real rates to rise?

February 28, 2021

The significant increase in yields continued this week, with the 10-year US Treasury yield rising by over 40 basis points (bps) before retracing on Friday evening. Equity markets continued to suffer from the spike in rates volatility and rise in risk aversion. While it appears that the wonderful window of opportunity from August to early February is now closed, it doesn't mean that our outlook for equities has changed. Rather, we recognize that gains will likely be more gradual and will need to be supported by a solid economy and increasing corporate earnings.

Highlights

▪ Following the rapid rise in bond yields since the start of February, major global benchmarks pulled back sharply. Long duration assets such as interest-rate sensitive technology stocks and emerging markets equities bore the brunt of the correction.

▪ The typical correlation between yields, equities and sectors broke down, with risk aversion rising, while value outperformed growth stocks markedly this week.

▪ Central bankers across the world tried to smooth the movement in rates through verbal intervention.

▪ Spreads have been tightening across the board and particularly in the lower quality layers, such as high yield and even more so in CCC-rated credits.

Markets & Macro | How much will the Fed allow real rates to rise?

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Dovish forward guidance is no longer enough.

Yields moved significantly higher this week with the 10-year US Treasury yield rising by more than 40 bps, before short covering saw it retrace and end the week at 1.40%. Equity markets continued to suffer from the spike in rates volatility, and particularly from the move in short and medium-term rates (with a full repricing of the Fed Funds rate path), and the rise in real, not just nominal, yields.

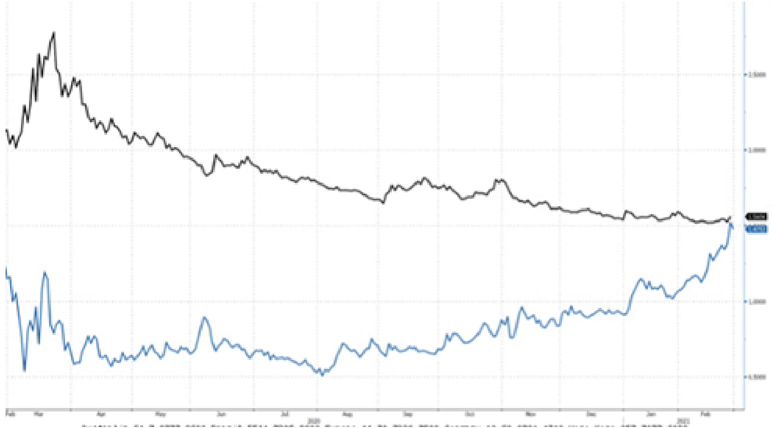
Our view: The rise in real rates is partly driven by an increase in inflation expectations, which has hit assets with embedded long duration (such as growth stocks, whose revenue streams are expected to materialize far into the future) and reflation sensitive assets (equities and commodity currencies). Matters weren't helped either by stronger-than-expected economic data, including US jobless claims and a solid durable goods report.

The typical correlation between yields, equities and sectors broke down, with risk aversion rising, while value outperformed growth stocks markedly. While it appears that the window of opportunity from August to early February is now closed, it doesn't mean that our outlook for equities has changed. Rather, we recognize that gains will likely be more gradual and will need to be supported by a solid economy and increasing corporate earnings. Going forward, sector differentiation and security selection will play a key role in driving performance.

To prove this point, we recognize that some investors in the market, namely pension funds and insurers, may start to see value in bonds, thus diverting flows toward the asset class. Figure 1 shows how the 10-year Treasury yield (the blue line) closed the gap relative to the S&P 500 index's forward dividend yield (the black line) this week.

Figure 1: US 10-year Yield versus S&P 500 Index Forward Dividend Yield

"...there is a limit to how much the Fed will allow real rates to rise since they constitute an unwelcome tightening in financial conditions (which is already apparent in US mortgages)."



Source: Bloomberg, as at February 26, 2021.

Other central bankers across the world tried to smooth the movement in rates through verbal intervention. The European Central Bank (ECB) was certainly more vocal than the Federal Reserve (Fed) in trying to contain the move in rates. Chief Economist Lane said that the central bank would "purchase flexibly according to market conditions with an objective to prevent a tightening of financing conditions", while the Executive Board's Schnabel said that a "too abrupt increase in real interest rates on the back of improving global growth prospects could jeopardize the economic recovery." President Lagarde stressed that "the ECB is closely monitoring the evolution of longer-term nominal bond yields," in a sign that the Governing Council is uncomfortable with the recent increase in long-term yields. And in Australia, the central bank also conducted yield curve control and materially intervened in the market in order to safeguard its target level on the 3-year maturity rate.

In the US, bond hawks noticed that the Fed is not overly concerned about the rise in yields, which suggests that the central bank will not react to it immediately. And rising yields driven by better growth expectations are actually a good sign for the health of the economy, which is now supported by the distribution of the vaccines.

That said, there is a limit to how much the Fed will allow real rates to rise since they constitute an unwelcome tightening in financial conditions (which is already apparent in US mortgages). In fact, after the move in short-term rates, the market is now pricing in two full rate hikes before the end of 2023. The Fed will have to find a way to manage this phase, without losing credibility or being judged as being 'late' by the market.

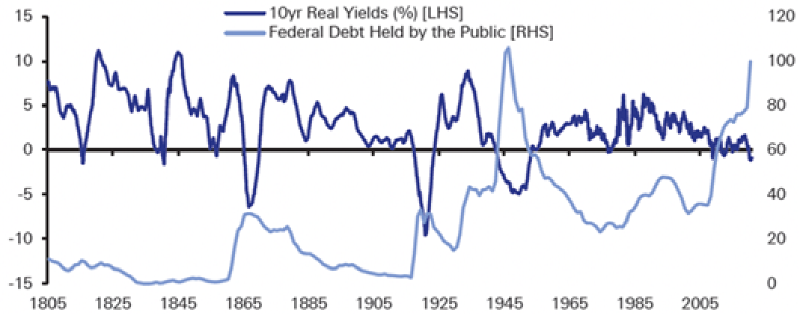
"There is also a new market awareness that there is inconsistency between growth expectations and monetary policy expectations – and this is the current problem."

We are already reaching a point where reassuring words, dovish forward guidance and unchanged dots plot are likely not enough anymore. Reassurances and reiterations of forward guidance have a way of becoming "unsatisfactory" for markets that are too comfortable with extremely loose monetary conditions priced into valuations. Further, it is the speed of the move that has the tendency to do the damage (in general, a 50 bps rise in yields in one month has a different impact than one hike in six months). The reaction was enhanced by very extreme sentiment and positioning, and a persistent overweight in those sectors with the most to lose from a rate hike, such as large caps and technology.

There is also a new market awareness that there is inconsistency between growth expectations and monetary policy expectations – and this is the current problem. However, the implications are not necessarily (all) negative. As mentioned, it was important to see a stabilization in yields on Friday. Yet, if it doesn't prove to be enough, starting with the short end of the curve, our bet is that the Fed will likely start to become concerned about the current move in yields and the potential unwelcome tightening in financial conditions – and they will act accordingly.

To this point, Figure 2 shows what happened to real yields in the past century, when levels of public debt exploded in comparable magnitude to the reaction to the pandemic. Real yields tended to fall far more than current levels (now at -0.5%, while they reached -5% to -8% in the past). Yet, the most relevant decline in yields occurred in the years subsequent to the debt explosion, when inflation rose and policymakers held rates artificially low for years.

Figure 2: US 10-year Yield versus Public Debt Holdings



Source: Deutsche Bank.

"As economic momentum remains solid, we expect equity markets to remain resilient. We also see the increase in interest rates as manageable given the ongoing strong growth expectations."

Equities | Taking a defensive stance for now

We are well-positioned to add to the reflation theme.

Following the rapid rise in bond yields since the start of February, major global benchmarks pulled back sharply. Long duration assets such as interest-rate sensitive technology stocks and emerging markets equities bore the brunt of the correction with the Nasdaq Composite index suffering its worst drop since October and the Shanghai Shenzhen CSI 300 index losing 7.7%. Energy and financials stocks outperformed, although the sell-off turned more broad-based on Thursday and Friday. The well-followed actively managed ARK Innovation ETF (ARKK) was down 14.6%, with the first weekly outflow in a year of USD691 million.

Figure 3: Global Equity Market Performance

	Value	WTD % Chg	MTD % Chg	YTD % Chg
Dow Jones	30,932.37	-1.70%	3.43%	1.41%
S&P 500	3,811.15	-2.41%	2.76%	1.71%
Nasdaq	13,192.35	-4.90%	1.01%	2.47%
Euro Stoxx 50	3,636.44	-2.07%	4.57%	2.65%
FTSE 100	6,483.43	-1.92%	1.58%	0.78%
CAC 40	5,703.22	-1.22%	5.63%	2.88%
DAX	13,786.29	-1.48%	2.63%	0.49%
FTSE MIB	22,848.58	-1.24%	5.92%	3.15%
Nikkei 225	28,966.01	-3.47%	4.75%	5.59%
Hang Seng	28,980.21	-5.43%	2.46%	6.42%
CSI 300	5,336.76	-7.65%	-0.28%	2.41%

Source: Bloomberg, as at February 26, 2021. Performance figures in indices' local currencies.

Our view: As economic momentum remains solid, we expect equity markets to remain resilient. We also see the increase in interest rates as manageable given the ongoing strong growth expectations.

That said, we believe that the heavy positioning in long duration assets (according to BAML, the third largest inflow to tech ever of USD4.5 billion) coupled with the technical factors (convexity hedging) pose a credible source of further near-term downside risk. Therefore, we are taking a defensive stance by reducing the net exposure of the equity portfolio until we witness signs of the market froth subsiding. With the cash balance at roughly 5%, we are well- positioned to add to reflation theme stocks (mainly financials and commodity names), thus reducing the duration of the portfolio. Also, we continue to recommend to clients to stay clear of stocks with high debt levels (net debt/EBITDA is our favorite measure), given their negative correlation to bond yields.

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Chart of the week

The last two corrections of the E-Mini NASDAQ 100 future stopped above the 100 Daily Moving Average (the yellow line), and both materialized in the last days of February. Indeed the key support to monitor is the 12500 level (100 DMA). The break of the support could trigger a second leg of correction with the target of the 200 DMA (-9% from spot).

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Figure 4: E-Mini NASDAQ 100 Future

Source: Bloomberg, as at February 26, 2021.

Fixed Income & Credit | Credit markets reflect growing optimism

High yield bonds outperform year-to-date.

With global bond yields rising sharply over the past few weeks, some central banks have shown signs of concern – the ECB said that it is "closely monitoring" the situation, the Reserve Bank of Australia resumed buying bonds and the Reserve Bank of New Zealand decided to take into account the development of real estate prices. On the other hand, the Fed only acknowledged that the rise in yields reflects "growing optimism in the strength of the recovery and could be viewed as an encouraging sign of increasing growth expectations."

Our view: This is exactly what the credit market is thinking if you look at the movement in spreads. As shown in the tables below, spreads have been tightening across the board and particularly in the lower quality layers, such as high yield and even more so in CCC-rated credits.

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	current			spread change		total return	
	spread	yld	dur	1M	YTD	1M	YTD
2Y US Treasuries		0,17	1,84			-0,09	-0,08
5Y US Treasuries		0,78	4,78			-1,72	-1,93
10Y US Treasuries		1,50	9,23			-4,09	-5,17
High Grade	95	2,14	7,86	-7	-8	-2,93	-3,70
BBB	119	2,39	7,7	-8	-11	-2,71	-3,28
7-10	103	2,33	7,18	-7	-7	-2,65	-3,32
High Yield	342	4,3	3,46	-33	-44	0,41	0,90
BB	250	3,45	4,23	-25	-29	0,10	0,26
B	378	4,59	2,62	-29	-35	0,45	0,79
CCC	658	7,27	2,27	-83	-145	1,68	4,11

	current			spread change		total return	
	spread	yld	dur	1M	YTD	1M	YTD
Euro		0,04	8,43			-2,49	-2,84
German Gov		-0,37	8,15			-2,56	-2,63
Ita Gov	89	0,50	7,5	-15	-3	-0,80	-1,69
High Grade	87	0,37	5,24	-3	-6	-1,08	-0,91
BBB	103	0,53	5,05	-5	-9	-0,94	-0,68
7-10	98	0,6	7,56	-3	-5	-1,82	-1,60
High Yield	310	2,56	3,4	-28	-45	0,66	1,31
BB	234	1,81	3,69	-19	-30	0,37	0,85
B	406	3,48	2,76	-39	-59	1,00	1,65
CCC	766	7,1	2,52	-99	-178	2,62	4,90

	current			spread change		total return	
	spread	yld	dur	1M	YTD	1M	YTD
EM $ SOV	275	4,04	8,32	-13	-11	-2,59	-3,74
EM $ CORP	265	3,52	5,14	-26	-25	-0,51	-0,86
EM SOV (LC)		3,80	6,74			-1,16	-1,19
* curncy ret						0,22	0,03
* TR Converted $						-0,93	-1,17

Source: Bank of America, as at February 26, 2021.

This is also confirmed by the activity in the primary bond market where junk bond sales continue to see robust demand. Issuance this year has reached almost USD84 billion, which is already close to surpassing 2012 to make this the busiest first quarter on record.

However, returns tell a completely different story. The sharp sell-off in government bonds has pushed the investment grade and emerging market segments into negative territory for the month and year-to-date as well. Despite the tightening, historically very low starting levels of spreads were not enough to compensate the brutal uptick in government yields. High yield bonds, which traditionally have lower duration, were better equipped to contain this movement and are displaying positive returns.

Week Ahead | Key events to watch for

- **In the US, February's ISM manufacturing and services reports and the monthly jobs report** will attract attention next week.
- **Attention on central bank speakers, starting from Fed Chair Powell,** will be extremely high, trying to interpret their reaction to the recent rise in sovereign bond yields throughout the world.
- **The UK government will be announcing their latest budget on Wednesday.** It will be critical to see the composition of new revenues, since the Chancellor of the Exchequer Sunak recently hinted to the possibility of raising corporate taxes to fix the budget.

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