Peaked Early? - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 103. Peaked Early?, presented by BMO Capital Markets. I'm your host, Ian Lyngen, here with Ben Jeffrey, to bring you our thoughts from the trading desk for the upcoming week of January 19th. As we ponder the probability that 10-year yields retest 1.19 in short order, we're reminded that repricings are like a box of chocolates, rewarding at first, but in the end, a sticky mess that requires effort to reverse the damage.

Speaker 2:

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Ian Lyngen:

Each week, we offer an updated view on the US rates market and a bad joke or two. But more importantly, the show is centered on responding directly to questions submitted by listeners and clients. We also end each show with our musings on the week ahead. Please feel free to reach out on Bloomberg or email me at ian.lyngen@bmo.com with questions for future episodes. We value your input and hope to keep the show as interactive as possible. So that being said, let's get started.

In the week just past, the Treasury market saw a very meaningful repricing or continuation of the repricing that started with 2021. 10-year yields got as high as 1.19%, which for the time being at least will mark the upper bound for the trading range that we expect to remain in place for the next several weeks.

Ian Lyngen:

Now accompanying this relatively volatile week in Treasuries, we saw a very strong reception to the 10-year reopening auction of 38 billion. The stop through was seven tenths of a basis point. Similarly, the 30-year of 24 billion stopped through 1.4 basis points. This ultimately served to reinforce the range and mark the departure for a bull flattening that brought 10-year yields back to 1.07, give or take. On the data front, we saw a relatively benign core inflation print of one tenth of a percent for the month of December. Now this is relevant in so far as part of the big 2021 trade is this reflationary narrative in which all the stimulus that has been put into the system ultimately leads to upward pressure on consumer prices. Now, the fact that this didn't materialize in December isn't particularly troubling for those assumptions.

Ian Lyngen:

More importantly, we'll continue to draw the distinction between realized inflation and inflation expectations. As long as inflation expectations for the out years continue to remain elevated, certainly by the standards of 2020, that will keep in played this steepening bias in the Treasury market. As we saw on Friday, an increase in inflation expectations as evidenced by the University of Michigan survey, one year inflation expectations increased to 3% from two and a half, and five to 10-year expectations increased to 2.7 from 2.5. This will surely serve to further reinforce the upward pressure on breakevens with 10-year breakeven solidly above 2.10 as we head into the weekend. There were two major disappointments on the economic data front. One was retail sales on Friday, which showed a sharp decrease in the control group for that series.

Ian Lyngen:

Now, this is important because it marks the third consecutive drop encompassing all of the fourth quarter. Now, given the relevance of consumption to the overall state of the economy, if anything, this will put a downward bias on some of the estimates for fourth quarter growth. We also saw initial jobless claims nearing the 1 million mark, which serves as a reminder that there's still a fair amount of slack in the labor market, as the pandemic continues to define the agenda for the real economy.

Ben Jeffery:

So what happened to 1.25?

Ian Lyngen:

We'll get to 1.25 in 10-year yields sometime in 2021. But the key takeaway from the week just passed was that it will not occur in the first two weeks of January. And I actually think that we'll struggle to see a retest of that 1.19 level in 10-year yields for the next several weeks, at least. If we think about what we have on the horizon, there's really very little of note for the next week or so. The Fed isn't going to do anything at their FOMC meeting so we're really left just to trade expectations for what will probably be a pretty uninspired fourth quarter GDP print on the 28th of January.

Ben Jeffery:

And while we didn't get to 1.25 right out of the gate to start the new year, that's not to say this past week didn't reveal some pretty important information. Most notable of which was December's retail sales data, which showed the fourth largest monthly drop in the control group, which corresponds most closely to consumption and GDP on record. This at a time that is traditionally associated with the holiday shopping season, and the disappointment really raises the specter of what could be a pretty disappointing fourth quarter growth profile.

Ian Lyngen:

Yeah. I think that the phrase underwhelming is going to be most useful in this context because we do have some sectors of the economy that will continue to perform, but given the relevance of goods consumption at this point in the recovery, I think it's safe to say that people will be ratcheting back their expectations for overall growth for 2021.

Ben Jeffery:

And that brings us to what was another core topic this week, which is the debate surrounding the timing of the FOMC's decision to begin tapering its bond buying. We heard from Raphael Bostic, who said that he would be open to beginning the wind down of purchases as early as the end of 2021, which I would argue contributed at least on the margin to 10-year yields run up to that 1.19 level we saw just before the reopening auction.

Ian Lyngen:

We also had offsetting comments from Vice Chair Clarida, who noted that the size and composition of QE is going to remain stable throughout the year. That corresponded with when we saw rates peak and a bit of both flattening start to re-emerge in the Treasury market, which really did define the course of the week that just passed.

Ben Jeffery:

And especially after taking into account the retail sales data, the economic realities shown in December, but still the slow economic progress out of the pandemic is going to advocate for accommodative monetary policy for the foreseeable future. And in addition to Vice Chair Clarida's comments, Powell made a very crucial point in his remarks, which is that in order to sustain Fed credibility concerning their new framework, once inflation does begin to pick up and eventually cross that 2% target level, even then the Fed is going to need to remain patient in taking away any accommodation simply to reinforce their credibility on the new inflation framework.

Ian Lyngen:

It's interesting that the knee jerk trade following Powell's comments was actually a steeper curve and it was a bear steepener at that. It does follow intuitively because what the Fed is saying is that they're going to keep front end rates lower for much longer than we've seen in prior cycles, even if inflation eventually comes back into the system. That is by definition a steepener. What is notable, however, is that the steepener that we saw in the wake of Powell all occurred well within the defined range that had already been in place. So if anything, the recent price action simply serves to reinforce our ongoing range trading thesis as 2021 unfolds. I also think it's worth highlighting that we did get the break of 1% that was driven by optimism for the year ahead.

Ian Lyngen:

This is very consistent with the seasonal patterns and the question now becomes, how much more upward momentum for rates will we see in the first quarter, or will 1.19 mark the upper bound for the time being?

Ben Jeffery:

And the context of risk assets performance alongside this increase in yields is also important in gauging the reaction function going forward. The fact that rates rose to their highest levels since the pandemic began, but yet equities were able to stay basically within striking distance of the all-time highs adds a degree of sustainability to this bearish repricing we've seen to begin the new year. Instrumental in this logic is the delayed blue sweep and aspirations around what has been proposed to be a $1.9 trillion third round of fiscal stimulus. But nonetheless, this sort of equilibrium that we've settled into in the first two weeks of the year has been encouraging in keeping financial conditions easy, at least from the Fed's perspective.

Ian Lyngen:

I was actually pretty surprised that we didn't see a more significant risk on impulse resulting from the fiscal numbers. $1.9 trillion for the Biden deal created some pretty impressive headlines and stocks didn't even budge. In fact, equities were off a bit on that. And I would argue that a fair amount of the muted response was a function of concerns about how quickly such a deal is able to actually make it through Congress. Yes, we did see a delayed blue sweep, but the fact of the matter remains that even within the Democratic Party, it stands to reason that there will still be some pushback on some of the more dramatic aspects of the package. The more than doubling of minimum wage comes to mind. Yes, Ben, that means that you're getting a raise.

Ben Jeffery:

And we've already seen lawmakers on both sides of the aisle come out and make exactly that point, Ian. Just as an example, Senator Rubio was on record saying that while he supports more direct payments, there's other aspects of such a large package that he disagrees with. Clearly, this line of thinking is not isolated to just a few senators, so all the initiative for more fiscal aid is encouraging from an economic support perspective. The fact that so many facets of the agenda are all encompassed in this bill does extend the timeline that will likely be required to get some form of an agreement on the law books. I think it's probably a pretty low likelihood event that everything proposed by President-elect Biden ultimately makes it through. And that means that over the coming weeks, headline watching from D.C. will probably still be relevant.

Ian Lyngen:

And the disappointing retail sales actually stresses the need for additional fiscal stimulus, given the winter wave of the pandemic and the reality that the real economy continues to struggle. Translating this to the rates market, very consistent with the fade of the initial upward pressure on 10 and 30-year yields, it also bodes well for our assumption that at some point in the coming months, we will see a retest of that 75 basis point level in tens. For the time being, repricing above 1% will continue to dominate the macro narrative. But as we think about the next couple of months, we will start to get a better sense for just how poor the real economy is performing.

Ben Jeffery:

And this week's reopening auctions can also take a little bit of credit for the moves we saw and the bull flattening reversal that really became thematic in the later part of the week. The strength of the bid that met both tens and thirties was remarkable. In thirties' case, we saw the highest non-dealer sponsorship on record at a time when 30-year yields are still well below 2%. It wasn't that long ago that that would have been almost unthinkable, but yet two very robust auctions for duration this week that supports this idea that demand is waiting at higher yield levels and will ultimately serve to limit the extent that rates can rise over the balance of the year. That clearly doesn't take a retest of 1.19, a break of 1.19 off the table, but rather it will make a paradigm shift back to 2% tens, extremely difficult in the medium term.

Ian Lyngen:

2% tens to be sure. I worry that the strength of the economic headwinds will prevent us from getting to 1.50 before we see the equity market start to wobble as a result. It's also notable that if we look at 10-year yields at the current levels hedged into yen for the Japanese investor base, we see the highest yield in Treasury opportunities for the Japanese investor since 2017 at roughly 75 basis points. Keep in mind that throughout the bulk of 2020, hedged yields were actually negative for Japanese investors and they were still adding duration exposure. I suspect that when the final data comes out, we'll see that the forum bid was very significant at the January reopening of 10 years.

Ben Jeffery:

So taking all of this into account and going into a short week without any real top tier fundamental inputs, what's our bias? Long, short, flattener, steepener?

Ian Lyngen:

In all seriousness. I think that what we have seen play out during the first two weeks of the year was really a culmination of the most bearish factors that the Treasury market might've experienced. And the fact that even in that environment, 10-year yields failed to break 1.20, that certainly reinforces the range trading notion and I'd expect that the next week will be spent with Treasuries consolidating within the range. For tens, that range will be between 1% and 1.15, let's call it, with a bias for both flattening in the very near term.

Ben Jeffery:

But as everyone's favorite Keynesian adage reminds us, in the long run, we're all-

Ian Lyngen:

Immune?

Ben Jeffery:

Yep. That's the one.

Ian Lyngen:

In the week ahead, the holiday shortened trading week has very little economic data of note. We do see existing home sales on Friday, but overall as a theme, we will be focused elsewhere. The drama that continues to play out in Washington will be relevant and it's notable that the 1.9 trillion in proposed stimulus hasn't had a greater upside impact on risk assets. Now this could simply have been a buy the rumor, sell the fact dynamic. However, we're not operating on the assumption that everything in the proposal will go through as is and expect that the political process will drag out, thereby reducing expectations for an immediate boost to consumption in the first quarter. The spending profile overall in Q4 suggests that additional stimulus will be needed, especially if lawmakers have the objective of bridging the gap to the end of the pandemic.

Ian Lyngen:

Progress on the vaccination front while steady, continues to be in the early stages and we have yet to see a leg higher in any optimism associated with the reopening of the real economy. Instead, the winter wave continues to lead to additional closures and restrictions and thereby curtailing any upside for the real economy. As we ponder the near-term direction for Treasuries, range consolidation appears to be the path of least resistance. On the upside for rates, the 1.19 level in 10-year yields will remain a key line in the sand and 1% in the event that we see a more significant rally. The price action has worked off a fair amount of the oversold momentum that was evident in stochastics when we look at tens and thirties, which implies that the period of consolidation could resolve with another push toward higher rates.

Ian Lyngen:

That said, our current stance is given the relatively empty calendar, the price action itself could prove to be the event. And as we skew the risks, a bullish period where 10-year yields managed to slip below 1% could easily serve as a departure point from more aggressive bull flattening.

We've reached the point in this week's episode where we'd like to offer our sincere thanks and condolences to anyone who has managed to make it this far. And as we face down a winter working from home, we gain new respect for the voyagers of years past who spent weeks alone on the high seas. But at least we have you, right, Wilson? Wilsonnn!

Thanks for listening to Macro Horizons. Please visit us at bmocm.com\macrohorizons. As we aspire to keep our strategy effort as interactive as possible, we'd love to hear what you thought of today's episode.

Ian Lyngen:

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