Recovery Reckoning - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons, episode 104, Recovery Reckoning, presented by BMO capital markets. I'm your host, Ian Lyngen, here with Ben Jeffery, to bring you our thoughts from the trading desk for the upcoming week of January 25th. And with Valentine's day quickly approaching, we find ourselves scouring the Amazon in search of pink Bermittens… and we thought 2021 couldn't be any worse than last year.

Speaker 3:

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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, this 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 add I-A-N.L-Y-N-G-E-N@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.

Ian Lyngen:

The week just passed in the Treasury market was a telling one in so far as what didn't happen, more than it might've been informative from the price action that actually occurred. What we saw was a consolidation in the Treasury market with 10 year yields above 1.07% and below the local high of 1.186%. This is relevant in so far as the market continues to build an important volume bulge in what traditional technical analysis would characterize as a pennant formation.

Ian Lyngen:

Now historically, those do tend to break out toward higher rates, so bearish in this scenario. However, we think there are reasons to assume that that won't necessarily be the net result from this period of consolidation. Our logic here is relatively straightforward and it effectively comes down to, if given all of the bond bearish events that have occurred thus far in 2021 are insufficient to make the repricing above 1.15% sustainable, then it will be a meaningful struggle to justify the current levels unless we have some incremental bear influences.

Ian Lyngen:

Moreover, a lot of the repricing was based on expectations that have yet to come to fruition, whether that's on the reflationary side or the fiscal stimulus side. In the final count, the risk is that these expectations go at least partially unfulfilled. This is the most significant risk over the next coming months. Now, given the backdrop of Fed QE, a move lower in nominal rates does not necessarily imply that break evens won't stay above 200 basis points.

Ian Lyngen:

It's very easy to envision a scenario where we continue to see the grind higher and break evens with inflation expectations anchored to this notion that the massive amount of accommodation currently in the system will ultimately lead to true demand-side consumer price inflation, while at the same time, our range trading thesis in the nominal market continues to hold.

Ian Lyngen:

When we think about drivers of inflation, the dollar continues to come to mind. The ongoing depreciation of the dollar sets the US economy up for the risk of importing inflation. Now, this is far more relevant for headline CPI, with dollar traded commodities as the obvious highlights. Oil is typically top of mine but if we look at the price action in copper, for example, we continue to see a drive higher based on reopening optimism.

Ian Lyngen:

This is price action, which is consistent with the slow return of term premium. Although it's worth highlighting that this return of term premium really involves going from negative term premium to slightly less negative term premium. Nonetheless, it is consistent with a steeper curve, which is part of one of the most crowded trades for 2021 and while the fundamentals are difficult to argue, will suggest that we're nearing levels where a tactical bull flattener begins to make a lot of sense.

Ben Jeffery:

So I think the biggest takeaway from the past several days has been short week, small range.

Ian Lyngen:

Small range, indeed, and I've actually been very surprised at how unwilling the Treasury market is to either extend the bearishness or see a retracement represented by a bull flattening. I came into the week expecting that because 10 year yields struggled to get to 1.20, that the next stop would be through 1.07% and back down to 1%. The reality was that the Treasury market spent the bulk of the week coiling in a way that from a technical perspective, would historically be consistent with a breakout toward higher rates, which does leave me somewhat cautious of my expectations for the next meaningful move to be back toward 1%.

Ian Lyngen:

That said, my core thesis at this point, is really this idea that all the major bearish inputs have occurred during the first two weeks of January. We had the delayed blue sweep, the push for the reflationary trade. We had a bunch of supply come to the Treasury market and still we struggled to get to that one 25 level in tens. And as we look to the balance of January and through February, a lot of those assumptions are going to be challenged. How much of the $1.9 trillion fiscal proposal from Biden will actually make it into law? That's a big one and that's one that we won't have true clarity on for quite some time.

Ben Jeffery:

And briefly on the fiscal plan, the reaction, or I guess, lack there of, to Yellen's testimony on Capitol Hill, really points to the fact that the next fiscal deal is pretty much reflected in prices at this point. I do think over the coming weeks, lawmakers will deliver something, whether that be direct payments or increased funding on the Federal level to help roll out vaccines, but some of the longer term issues such as increasing minimum wage, unemployment insurance, things of that nature, will be critical political developments to monitor now that the new administration is officially off and running.

Ian Lyngen:

And let us not forget that the delayed blue sweep did not give the Democrats a particularly large majority in Washington and the relatively narrow margin implies that it will be a lot more difficult to push through some of the wholesale changes that one might have otherwise anticipated had the composition of Congress been slightly more weighted toward the Democrats.

Ben Jeffery:

And in talking about this week, I think we'd also be remiss not to mention the performance of risk assets. We saw the S&P 500 make it to record highs once again, and the start to corporate earnings season get off to a decent start for the fourth quarter. This sets the stage for the fourth quarter GDP print, which will offer welcome clarity on the pace of the recovery to end last year. And with current consensus sitting just North of 4%, an extension of the expansion to conclude 2020 is certainly consensus, even if a dip back to negative growth in the first quarter is certainly still a risk.

Ian Lyngen:

Yes. And I would add that the wide error bands around estimates of all economic data during the pandemic really does speak to the fact that we might see a double dip earlier than the market is expecting. That said, when we look at how the market has reacted to such misses over the course of the last couple of months, for example, NFP, I wouldn't expect that even a negative GDP print would materially alter investors expectations for the recovery throughout the course of 2021. It would reflect the realities associated with increased lockdowns, higher case counts of COVID-19 and the progress through the dark winter of the pandemic.

Ben Jeffery:

And we talk a lot about the market's willingness to look toward what the new normal may ultimately look like. It's still fair to say that vaccinations will have progressed to such an extent that some version of normal will have commenced early in the second half of the year and that timeline is reinforced by what's expected to be approval of more vaccines in the coming week, some of them being single doses and not requiring quite as much infrastructure to store.

Ben Jeffery:

But really even after we've hit the point where masks are no longer required, restaurant capacities ramp back up, there is still the outstanding uncertainty of just how willing people are going to be to resume commuting as they once did, resume spending on services as they once did, which is just a longer way of saying, how much of the pandemic lifestyle will be carried forward for the next several years? I think working home comes to mind as really the top tier example of that.

Ian Lyngen:

And limited business travel is also a key takeaway. One macroeconomic issue that has been especially topical during the first couple of weeks of January is refining expectations about the inflation complex over the course of the next few months, we all get the reflationary trade that at some point, all of the stimulus coming from the Fed as well as Washington will eventually lead to higher consumer prices. But in the near term, we see the base effects created by the March, April and may drop in prices as the most tangible input to see a near term spike in realized inflation. Now we'll continue to emphasize the difference between actual realized inflation and inflation expectations as more than a nuance and what might ultimately leave the market in a situation where core inflation continues to grind along at a benign pace while break evens continue to push to cycle highs. And there's a strong bid for inflation protection has evidenced by the 10 year tips auction, which stopped through 1.3 basis points.

Ben Jeffery:

And at the risk of sounding like a broken record, once again, we saw a record large auction stop through at record low yields. And on a shorter term time horizon, the sponsorship that met 10 year tips is made even more noteworthy just given the fact that we saw a pretty meaningful pickup in real yields last week, and that was almost entirely retraced going into supply. So that means the strength of the bid can be attributed less to accommodation immediately around the auction itself and more to strong structural demand for inflation protection at this point in the cycle.

Ben Jeffery:

There's also the fact that the Fed is going to continue to endeavor to keep really yields as low as possible, as a function not just of policy rates at the effective lower bound, but also a QE program that continues to run at $80 billion a month in Treasuries and $40 billion a month in mortgages. So this means that real yields and tips should continue to perform well given the fact that QE is broadly expected to run at its current pace through the end of 2021.

Ian Lyngen:

We stumbled across an interesting survey by one of the major media outlets recently that showed, of the street economists surveyed, that the majority of them expect that QE in its current form, which as you point out is $120 billion a month of balance sheet expanding bond buying, should extend through 2021. Now that is somewhat at odds with the conversations around the re-steepening that we saw early in January, where many market participants were talking about the Fed tapering its bond buying as a reason that the curve should be steeper.

Ian Lyngen:

It's also notable that discussions about a WAM extension seem to have subsided for the time being. I attribute that to the perception that the recovery remains on track and a renewed emphasis on support from the fiscal side, with the Biden administration picking up the mantle of bailout funding.

Ian Lyngen:

As we think about this pivotal moment that we're in for the Treasury market with 10 year yields at effectively 1.09 and the dueling expectations for a push to 1.25 versus a dip below 1%, it strikes me that there is a false sense of equilibrium. And by that I simply mean to keep yields at a higher plateau, we'll actually need to see the fulfillment of some of these bearish potentials that have driven us here. Whether that comes in the form of an improving outlook for the employment market or the realization of additional funding from Washington, remains to be seen. But one thing is safe to assume, if nothing that drove rates to 1.19 comes to fruition, we'll be back to 95 basis points in relatively short order.

Ben Jeffery:

And that dynamic's essential to consider over the next few months. And this brings me to a good point I've heard offered on the vaccine process specifically. Thus far in the rollout, vaccinations have been limited, not necessarily by the number of vaccines that have been distributed, but rather the regulations surrounding which subsets of the population can receive it. As more and more individuals received their doses of the vaccine, the massive amount of production that was undertaken before they were even being administered will start to run out.

Ben Jeffery:

Those stockpiles are going to start to diminish at a time when manufacturing bottlenecks may start to appear. Now, this is certainly not a base case, but if we hit a point of relative vaccine scarcity at a time when an even greater share of the population is even able to receive it, it's not difficult to envision a situation where there's plenty of people that are willing and eager to receive the vaccine, but simply by virtue of availability, there'll be unable to. Now, all this does is move the goalpost of herd immunity further into the future.

Ian Lyngen:

One of the good counterpoints to that is that we continue to see additional vaccines come online and make it through the approval process and some of these vaccines not only have their own stockpiles already in place, but might also ease some of the distribution problems, including the single versus double dose issue, as well as some of the storage concerns.

Ian Lyngen:

And Ben, as you point out, the regulations surrounding the timeline for people to receive the vaccines will remain relevant because even if there is enough supply, there's still the risk that we find ourselves with the eligible part of the population being reluctant to actually seek out inoculation.

Ian Lyngen:

That said, for the time being, the vast majority are simply waiting for their spot in the queue as we all plan our 65th birthday parties.

Ben Jeffery:

Ian, I mean, you should be good. You don't look a day over 75.

Ian Lyngen:

And a face made for podcasts.

Ian Lyngen:

In the week ahead, the Treasury market will have an array of fundamental inputs to help drive trading. The biggest being Wednesdays FOMC meeting. Now, while expectations are not for anything dramatic to come out of the meeting, it's still an event risk, including Powell's press conference after the fact.

Ian Lyngen:

We also get the first look at Q4 real GDP. Expectations are for the quarter’s annualized growth to be slightly above 4%, representing a moderation from the pace of growth that we saw in Q3, but nonetheless positive and consistent with the slow and steady progress out of the pandemic. The obvious risk here is that the pandemic-related restrictions and lockdowns led to a drift lower in service consumption as the quarter came to an end. So if forced to skew the risks, we'd skew them toward the downside.

Ian Lyngen:

Let us not forget that there is also supply on the horizon. We have 60 billion, two years, 61 billion, five years, as well as 62 billion, seven years. All of which we generally expect to receive relatively strong sponsorship from the non-dealer community who continue to be the underlying concerns that net supply will eventually reach a tipping point that forces a material repricing in the Treasury market to a higher rate plateau.

Ian Lyngen:

We're skeptical that we're nearing the point where this bond vigilante argument starts to make sense, but nonetheless, expect that a reasonable pre-auction concession will help drive the curve a bit flatter as front end supply is absorbed.

Ian Lyngen:

There's a reasonable argument to be made that this period of consolidation that we've seen in the Treasury market over the course of the last couple of weeks is poised for a breakout, either bullishly or bearishly. The technical landscape does favor the bearish side, which would put 1.18 to 1.19 in range for 10 year rates.

Ian Lyngen:

In the event that we see the draw of a lower rate range over power any bearish sentiment, we booked for the break of 1.07 in 10 year yields to clear the way for a move to 1%. If we do find ourselves back below 1% as the month ends, it will be very difficult to expect 1.25 will come to fruition during the first quarter.

Ian Lyngen:

The one asset class that has delivered relatively consistent performance thus far in 2021 has been the domestic equity market, and given the relevance of equity vol to financial conditions and ultimately the Fed's path of monetary policy, we'll continue to monitor closely for any wobbles or any evidence that the backup in rates has led to a reevaluation.

Ian Lyngen:

That said, we'll be the first to concede that the path of the pandemic and the passage of time will be key determinants in the pace of the recovery, as well as how long it takes for the employment market to ultimately heal. It's bringing in those sidelined workers that have been dislocated as a result of the initial lockdowns in the pandemic that will be the biggest challenge facing the economic recovery throughout 2021 and for that, we'll continue to look to the weekly jobless claims series, that are running a lot closer to one million new filers every week than we'd like to see at this stage.

Ian Lyngen:

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 with this weekend's pandemic entertainment provisions, including the Bills, Buffalo, not Treasury, Chiefs, Packers and Buccaneers, oh my, we're reminded it's football, not football.

Ian Lyngen:

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