One Down, Eleven to Go - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 105. One down, eleven months to go. 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 February 1st. The strangest thing happened on the way to the local corner specialty shop to pick up the newest edition of pong. We somehow feel 300% better.

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.

Ian Lyngen:

In the week just past, the Treasury market had a fair number of meaningful fundamental inputs to drive trading direction, although at the end of the day, the bulk of direction was extracted from movements in risk assets and a lot of that had to do with questions about valuation, about bubbles, and of course some story stocks with specific names outperforming and then underperforming the broader indices over the course of the week.

Ian Lyngen:

We did see updates on real GDP for the fourth quarter. The print came in at 4%, which we're interpreting as effectively consensus given that it was just a couple of tenths off, but more importantly, providing a further confirmation that the recovery has moderated but is still on reasonable footing. For context, it's important to keep in mind that the Fed's projections for growth for 2021 indicate that real GDP should expand by 4.5% over the course of the year. The operating assumption on the part of market participants is that Q1 and Q2 will struggle with a real risk of a double dip, but ultimately resolve a much stronger second half to the year.

Ian Lyngen:

Our primary concern with this narrative is the market is pricing in progression toward a post pandemic world by the end of the year, and given the current pace of inoculation and some of the headwinds that are being faced on the vaccination side, we find many in the market are pushing out that herd immunity date well into the second half. That's not to imply that the economy won't reopen, that's not to imply that we won't see some pent-up demand eventually work its way through the system. It really becomes a question of timing. And as we think about our year end forecast for 10-year yields at 125, we'll be the first to concede that part of that does assume that the economy will be a lot closer to fully reopened than we are at this point. And the perception will generally be that the medical community has contained the virus.

Ian Lyngen:

From a more immediate trading perspective, we did see the realization of the bull flattening that we were anticipating brought 10-year yields from the peak of 119 back to dip below 1%. And then we've transitioned to a period of stabilization and consolidation with 10-year yields between 1 and 110, let's call it. When we think about the next big move, we're going to need to continue the process of establishing a material volume bulge above 1% before the market is content to take another shot at 125 tens. Whether that actually occurs during the first half of the year is going to be a function of the path of the pandemic, as well as how the economic data unfolds over the course of the next two months.

Ian Lyngen:

Efforts on the part of lawmakers in Washington DC toward another round of fiscal stimulus continue to be a focus of market participants. The $1.9 trillion Biden package initially proposed seemed very unlikely to go through in its current state. Expectations are that that will be scaled back to a number closer to $1.25 trillion, although what is more important is the length of the process to get there. If in fact Congress can cobble together a compromise over the course of the next four to five weeks, that is one and a quarter, that will ultimately have a more significant upside influence on risk assets as well as higher pressure on rates than if a deal ultimately takes three months to come to fruition, even if at the end of the day it's larger in size.

Ben Jeffery:

Ian, it was really an exciting week in markets. In Treasuries, we came into the week actually getting through 1%, however briefly. And since then we've seen a retracement. 10-year yields are now back toward the middle of the range as it appears for the time being maybe a period of equilibrium is upon us.

Ian Lyngen:

Yeah, I think equilibrium is a reasonable way to describe it, either that or an extended period of consolidation. What we have seen is we've seen a rejection of the higher rates thesis. We never made it to 125, even though we had a confluence of all the more bearish events that we were expecting to transpire over the first quarter condensed into the first week of the year. But on the flip side, there seems to be a reluctance on the part of investors to push 10-year yields substantially or sustainably below 1%. I'm very sympathetic to the underlying reluctance to reprice back to a lower rate plateau, primarily because if we look at the big trade for 2021, and that's the reflationary trade, what we see is that continues to hold as evidenced by breakevens. We also had a higher than expected core PCE print on Thursday, which reinforced this notion that inflation will slowly start seeping back into the system, putting upward pressure on consumer prices and justifying higher rates further out the curve.

Ben Jeffery:

And additionally, in regards to the price action, a theme that was very well entrenched to end 2020 has clearly continued into 2021. And that is at this point that the shape of the curve is purely a function of how duration performs. Selloffs are going to be steepeners, rallies are going to be flateners. So yes, we saw a decrease in long end yields below that 1% level in 10-year space, but the retracement has also left the yield curve in a meaningfully steeper territory than we've seen for quite some time. This is purely a function of the Fed's influence on the front end of the curve. And while there was hardly a great deal of new information gleaned from the Fed meeting this week, the main takeaway was that rates are going to be staying where they are. And as Powell said it, it's far too early to begin the conversations around tapering bond buying.

Ian Lyngen:

Stable front-end rates are a given, I'll grant you that, but there's a bigger debate playing out in the Treasury market at the moment, and that is whether we are in an environment where we will see effectively a step function higher in yields as the course of the year plays out, i.e., if you go from 95 basis points to 105, you have a period of consolidation within a range. Then you ratchet that up to 115, 120, et cetera. That's not my core thesis. I expect what we'll see is while there will ultimately be progress toward higher rates over the course of the year, it will be more about defining the upper and lower bounds of a comparatively pretty significant range versus what we have seen thus far in the beginning of the year.

Ian Lyngen:

If we look historically, unless the market is in a moment of massive repricing comparable to what we saw in 2020 or what we saw in 2008/2009, then typically 10-year yields hold a range, on a 52 week look back basis, of somewhere between 75 and 100 basis points. If we apply that paradigm to the current trading environment, that means we could see rates above 125, 135 at some point, as well as a retracement back to that 60 to 75 basis point zone on a meaningful flight-to-quality bid that would most likely be associated with roadblocks on the drive to herd immunity.

Ben Jeffery:

And I would argue that January has been a pretty good example of that. We came into the year with a delayed blue sweep by the Democrats and accompanying fiscal ambitions. We saw inflation expectations pick up meaningfully, equity prices hit record highs, and really to steal your phrase, Ian, the bearish polar vortex that pushed 10-year yields to 119 represented the extent of the sell-off to start 2021. Subsequently, some of that optimism was walked back, hence we got to 99.4 basis points in 10-year yields, but I completely agree with you, it's this push and pull dynamic on the road back to normal that will likely define trading and Treasuries. On the path to herd immunity specifically, we did get some new information on Friday that J&J's vaccine is 66% effective against moderate and severe cases of COVID-19 and prevented 100% of hospitalizations and deaths resulting from the virus.

Ian Lyngen:

I'll have to be the first to admit that when I saw those stats and I compared them to the other vaccines that have already achieved FDA approval, I wasn't impressed.

Ben Jeffery:

And while we're by no means medical experts, I do think context is very important here, just given the fact that the mid 90% efficacy associated with some of the initial vaccines is very elevated in the context of inoculations more broadly. So while sure one would prefer to see a 95% versus 66%, it is still important to consider that this latest vaccine only requires one dose and the storage requirements associated with it are far less arduous than some that require pretty substantial refrigeration infrastructure in order to keep them viable. So really in practical terms, this should contribute to an accelerating pace of vaccinations, now that almost 22 million people domestically have received at least one dose.

Ian Lyngen:

One of the aspects of the price action associated with the J&J announcement that I found notable was its complete absence. We didn't see a bid for equities, we didn't see any material retracement in terms of rates. What we saw was a market that continues to focus on some of the story stocks in the equity markets and this push toward consolidation and rates. One might argue that what we're seeing is we're seeing a market that has priced in a continued, relatively slower than initially expected path toward immunity. And unless we see anything that challenges that notion, investors are going to be reluctant to engage in any wholesale repricings.

Ben Jeffery:

And while all of this was certainly meaningful for this past week of trading, really the broader macro themes remain unchanged. And perhaps most importantly in that regard is the trajectory of the labor market, an update on which we'll receive on Friday via January's NFP data. Current consensus for the headline number is sitting right around 50,000. And as we discussed last month, Ian, that definitively puts another negative print on the table, which would be another negative adjustment to the trajectory out of the pandemic from the labor market perspective.

Ian Lyngen:

It's also worth highlighting that we do continue to see, via the BLS series, this counter-intuitive increase in wages. Now, as a market, I think we understand that that's a compositional issue. So the fewer low wage earners that are currently employed, the higher the average number will ultimately be. It will be notable to see, once we start to emerge on the other side of the pandemic and re-engage many of the initially sidelined workers, how wage performance will play out. One of the broader concerns that I have over longer term wage inflation coming out of the pandemic is that some of the key changes resulting from the work from home movement will actually serve to contain wages. The logic there being you will have older workers who can see retirement but choose to stay engaged in the labor force simply because they've been able to realize some quality of life improvements by no longer needing to commute. They can remain in the labor force for a few more years, continue to build resources for retirement, and they don't necessarily need to see upside in terms of wages.

Ben Jeffery:

And there's another aspect of the work from home revolution that adds to this idea, Ian, and that is something we've talked a lot about, which is the shift by a large section of the population out of some of the more densely populated urban areas, aka higher cost of living, into other locations, whether that be the first or second ring suburbs, or even a bit further afield to some cities that continue to see a massive influx of new residents, particularly among that millennial cohort. Now, I think we're still early enough in the pandemic that firms have not yet begun the process of adjusting compensation to reflect where an employee may be working from, but going forward, it's certainly reasonable to anticipate that there will be some downward pressure on take home pay just as a function of where someone might choose to work remotely.

Ian Lyngen:

Let us not forget that if we can prove collectively as a workforce the ability to do our jobs effectively remotely, then there's this notion of fungibility of employees that I worry about. By that, I simply mean that distance from management eliminates some of the baseline day-to-day interactions and the social ties that people develop. And so, if it becomes more cost-effective to simply replace one widget with another, lacking that baseline connection, I suspect that that type of turnover might become more commonplace for workers who have made the trade-off between quality of life and proximity to power.

Ben Jeffery:

And quickly shifting gears outside of the labor market specifically, we do also get the February refunding announcement this week, the influence of which has certainly elevated, not only given our expectation for $1.7 trillion in that issuance in 2021, but also the massive error bands of uncertainty surrounding what size fiscal package the Treasury department will ultimately need to fund. So Wednesday morning, greater clarity on how Treasury under new management will approach the challenges of issuance will be instrumental in framing expectations for the primary market going forward.

Ian Lyngen:

Are we expecting to see coupon sizes increased on net on Wednesday?

Ben Jeffery:

We're looking for unchanged coupon auction sizes. But in this context, "unchanged" is taking into account the massive increases we saw throughout 2020. It's safe to say that coupon auction sizes are not going to be decreasing anytime soon and further up-sizing in the quarter ahead is absolutely on the table. It really becomes a question of conviction at Treasury to turn out the debt versus concentrating in bills. And ideally the information contained in this week's updates will help shed greater light on this topic.

Ian Lyngen:

As Congress continues its debate on how much of the $1.9 trillion in potential fiscal stimulus to approve, we also run up against the realities of the debt ceiling limit, and that could have implications for front-end funding. And I think that that warrants keeping in mind, especially as the market is poised to learn whether or not yelling can truly put the fun back into refunding.

Ben Jeffery:

And as surprised as I am to hear myself say this, there was some interesting moves worth discussing in the funding market this past week. Downward pressure on repo rates was largely attributed to a huge amount of cash at GSEs, and looking forward there's certainly more reason to expect that the enormous amount of cash in the system is going to limit how far any funding costs are going to be able to back up. You mentioned the debt limit in, and while it's still probably too soon to really have any high conviction on whether or not the Treasury department will need to run down their cash balance, the fact of the matter is with all this cash, there's a non-zero risk that we start to see effective Fed funds move lower as we did this past week. And while the Fed would be comfortable with EFFR at eight or nine basis points, if we get down to five, four basis points, it certainly wouldn't surprise me to see a policy response simply to protect the integrity of the lower bound.

Ian Lyngen:

So that actually sounds to me like less fun in refunding.

Ben Jeffery:

Who's Yellen now?

Ian Lyngen:

In the week ahead, the Treasury market will have some key fundamental inputs culminating in Friday's non-farm payroll report. As it stands, the consensus is currently for an increase of 50,000 jobs in headline non-farm payrolls. Now, given the proximity to zero and the notably wide error bands around all economic forecast in the midst of the pandemic, we will highlight the risk for yet another negative print, which would reinforce concerns that the dark winter of COVID has continued to weigh on the employment market into January, which should eventually have ramifications for spending overall consumption and ultimately the pace of growth in Q1, given the relevance of consumption to the US economy as a whole.

Ian Lyngen:

We'll also be focused on details within the official BLS report regarding labor market participation, not only broadly but also in some of the key consumer sections. Particularly the 25 to 34-year-old cohort has been occupying a fair amount of our attention given this age bracket's propensity to consume. Now, ahead of Friday's official data, the process of consolidation in the Treasury market is most likely to continue. We struggled to see any compelling argument to suggest that 10-year yields will retest that 119 level without something far more concrete on the bearish side. And it won't be any of the economic data over the next coming weeks.

Ian Lyngen:

What we might see is we might see the refunding announcement on Wednesday serve as a reminder to the market that the Treasury department has to fund a ballooning federal deficit with potentially more to come in the event that another round of fiscal stimulus finally makes it through Washington. The process of consolidation in Treasuries doesn't preclude an upward drift in breakevens that we expect to continue to be thematic over the course of 2021.

Ian Lyngen:

Currently 10-year breakevens are comfortably above 200 basis points. And as we see the drift above 211, a target of 225 doesn't seem unreasonable given the Fed shift in its monetary policy framework, combined with all of the fiscal stimulus that's already come out of Washington, as well as the efforts of accommodation made by the Fed. The bigger concern isn't whether or not there's enough fundamental justification for higher inflation expectations, but rather if those inflation expectations can be maintained while the near term realized inflation figures remain in relatively benign territory.

Ian Lyngen:

Let us not forget there are a variety of Fed speakers on the horizon, and as we attempt to get a better sense of the Fed's current stance of monetary policy in the wake of the recent decision to hold steady the existing policy stance, it will be notable to hear from both the doves as well as a few of the more hawkish members on the committee. Although it's being equal, we maintain that the Fed will keep their $125 billion a month QE bond buying in place through the balance of 2021. Whether that amount is tapered in Q1 or Q2 of 2022 will be a function of how quickly the real economy rebounds in the second half of this year.

Ian Lyngen:

We've reached a 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 the frigid weather giving way to forecast of significant snowfall, we're updating our streaming queue with instructional films on surviving the apocalypse in self-contained snowplowing speeding bullet trains. After all, 28 days later is so 2020.

Ian Lyngen:

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