Ready for the Weeknd - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons, Episode 106, Ready for the Weeknd, presented by BMO Capital Markets. I'm Ian Lyngen, here with Ben Jeffery to bring you our thoughts from the trading desk for the upcoming week of February, 8th. And as we prepare for 24 minutes of the Weeknd, we cannot help but reflect on band names of yore that created brands out of the commonplace. The Doors, The Who, The Cars, The Monkees, The Beatles, The Animals, The Cure, and The Long Bond. See what we did there.

Speaker 2:

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Ian Lyngen:

Each week we offer an updated view on the U.S. 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 few key inputs from a fundamental perspective to respond to in terms of pricing. We did see the as expected refunding announcement with $58 billion threes, $41 billion tens and $27 billion thirties, all to be auctioned in the week ahead. Now this has intuitively put upward pressure on rates in a classic supply accommodation trade.

Ian Lyngen:

On the jobs front it was a disappointing nonfarm payrolls print with the nuance being an unexpected decline in the unemployment rate. Overall, a somewhat disappointing take on the labor market for the time being as the impact of the pandemic continues to weigh on the economic outlook. What was notable within the price action was we saw an intuitive bid for Treasuries on the disappointing nonfarm payrolls print, but it wasn't able to reverse the bulk of the upside that we have seen in rates over the course of the week. What subsequently transpired was a bearish re-steepening that stalled out at an important technical support level for tens, which is 1.186% in yield terms. And that's a level that we'll be watching going forward as it does show some willingness on the part of market participants to buy a backup in rates and to some extent it does give credence to the range trading thesis as 2021 comes into better focus.

Ian Lyngen:

Fresh record high stock prices continue to represent the norm, especially we make it further through earning season and we continue to see upside in risk assets if for no other reason than simply the massive amount of monetary policy accommodation that there is in the system. We did have a better than expected ISM services print which is consistent with some of the budding optimism that had been brought into the beginning of the year. It will be notable to see how the market ultimately responds to the somewhat disappointing nonfarm payrolls print as it does two things. One is it level-sets expectations for growth in the first quarter, given the implications from consumption, et cetera, but it also makes an even better case for lawmakers in Washington who are attempting to push through yet another round of fiscal stimulus.

Ian Lyngen:

Reports from D.C. suggests that the blueprint has been approved and the groundwork is in place for some type of deal in the coming weeks. Whether that ends up coming to fruition in February or if it's delayed to March, does have incremental ramifications for risk assets and subsequently rates. However, it won't define the outright level of yields, nor frankly the outright level of equity prices. For that we'll continue to look at the path of the pandemic as well as the push toward mass inoculation, as well as any better understanding of exactly what the world will look like once we return to some version of normality. One thing that is safe to say is the 2021 normal will look nothing like the 2019 normal aside from record-high equity prices.

Ben Jeffery:

So January's payrolls data was disappointing and we got the initial bounce in Treasuries but it was pretty short-lived and in fact yields started moving higher. Ian, is this a reflection of next week supply dynamics, may be some bad news is good on the stimulus front?

Ian Lyngen:

I think it's a combination of both of those aspects of the macro narrative at the moment. On one side you did have a disappointing NFP print particularly within the details where we saw December revised, sharply lower, which if anything marks a relatively low departure point for the beginning of 2021 in terms of jobs growth and more importantly, the idea that the return of lockdowns is in fact having an impact on the frontline service sector and jobs creation.

Ian Lyngen:

One of the fascinating aspects of the data itself was we saw an unexpected improvement or decline in the unemployment rate to 6.3% from 6.7%. Now, a move of that magnitude I would have assumed would have been associated with either a much larger increase in headline NFP gains or a more decline in the labor market participation rate. What we saw was a relatively modest one tenth of a percent drop in overall labor market participation to 61.4%.

Ben Jeffery:

So, all the baby boomers are retiring, right?

Ian Lyngen:

Well, that's certainly one of the possible explanations. But if we look within the details of the data what we see is that the hardest hit group is that 25 to 34-year-old cohort, and that's going to be consistent with not only those being the employees who have historically been the first to be stopped out when the economy turns and firms need to downsize, but also a reflection of the nature of the pandemic and what closings of schools in particular mean for parents of young children. It follows intuitively that we've seen a drop in participation as at least one parent needs to stay home to fill the gap of childcare that in-person schooling had previously provided.

Ben Jeffery:

And ahead of the release we had heard the observation offered that say payrolls came in at 500,000, 600,000. That may have taken some of the pressure off of Washington to deliver on the next round of fiscal stimulus. If in fact the labor market recovery was accelerating faster than some were anticipating than maybe Congress and the White House could have erred on smaller direct payments or more focused direct payments. But the fact that the January data was weak and the December update was revised even weaker really serves to add at least a degree of urgency to the negotiations around getting the next fiscal deal through Congress. While it's currently up in the air how big the bailout package ultimately ends up being, our pre-NFP survey this past week centered around the $1 trillion to one and a quarter trillion dollar mark.

Ian Lyngen:

One of the things that I found particularly fascinating within the details of this week's survey was the fact that nobody is expecting either zero deal or a deal below $500 billion. So that does raise the bar for Congress to ultimately deliver and it speaks to this idea that there's a reasonable amount of fiscal stimulus priced in the market at current levels. Now, the two touchstones that matter in that context are record high equity prices and 10-year yields that continue to drift a bit higher. I was encouraged to see the post-NFP bid that brought 10-year rates back to effectively unchanged on the day and cleared the path to trade supply. And that's what we're doing right now and that will be the story between 9:00 AM on Friday and Wednesday and Thursday's refunding auctions for tens and thirties.

Ben Jeffery:

And going into supply what's really been most striking to me is just how similar this month's auction process appears to be playing out as it did in January. Recall that the last peak in 10-year yields was set on the day of the 10-year reopening as that of classic supply accommodation played out, and ultimately the liquidity point served as a good tactical buying opportunity as 10-year yields moved lower however briefly through 1%.

Ben Jeffery:

And within the details of January's auctions both for tens and thirties, what was most striking is the strength of the bid from domestic investment funds. In the case of thirties it was the highest take-down on record, which really speaks to a willingness by that investor base to take advantage of any backup in longer-dated yields in this historically low-rate environment.

Ian Lyngen:

Well, and let us not forget there are natural buyers of long bonds particularly on the ALM side and people who are simply hedging other exposures. So this notion that there will be a saturation point for Treasury issuance does remain relevant although I think there are key offsets that will presumably be put to test over the course of the next several auction cycles. All that being said, the traditional trading strategy of leaning along the Treasury auctions after the event will be topical, if not particularly prudent in the week ahead. My stance remains that the liquidity provided by the refunding auctions in particular is simply too enticing for big players in the Treasury market to completely ignore, so it's safe to say that the auction process will be smooth and certainly in a traditional sense.

Ben Jeffery:

And on the supply front it's worth just briefly mentioning the fact that the refunding announcement revealed coupon auction sizes are going to remain unchanged for the next quarter. Now, there was a little bit of a split consensus on whether the Treasury Department would ultimately decide to focus borrowing further out the curve, but for the time being they seemed content with the issuance profile as it is. On the margin this does suggest a bit more caution surrounding the speed with which they'll be able to pay down bills, but going forward it's going to be especially interesting to see the approach that the Yellen Treasury Department takes in their endeavors to finance the growing deficit.

Ian Lyngen:

Well, I think it goes without saying that eventually the Treasury Department's longer-term goal is to term debt further out and take advantage of these historically low rates. The art form behind that is to do it in such a way that doesn't disrupt the market and subsequently lead to higher borrowing rates further out the curve. And that's really the balance that Yellen will need to strike in this current environment, and to suggest that it might prove to be a difficult task would even be an understatement, frankly.

Ben Jeffery:

And outside of supply during the week ahead we also get January's inflation data, which is coming at somewhat of a pivotal time given the moves we saw in 10-year breakevens. They've traded through their prior local peaks to the highest level in years which is encouraging for the reflation trade and also for a Fed that is still endeavoring to let the economy run hot and inflation over that 2% target on a sustained basis.

Ian Lyngen:

I think it's key in this context to draw the distinction between realized inflation and inflation expectations. We can see sustainably higher inflation expectations as evidenced by breakevens, both 10-year breakevens as well as the five-year, five-year forward, even if we don't have that actually translate through to upside risk for inflation in the very near term. If we look at the consensus expectations for Wednesday's CPI, they're very much in line with what we tend to see for that series and do not suggest that we'll be facing a period of upside pressure on consumer prices that the Fed doesn't want to see.

Ian Lyngen:

One interesting question that we received this week was what's more important, inflation that comes from structural changes related to imports and restrictions on that side, are either focused on reassuring and Federal contracts going to domestic producer, or is it this notion that there's so much money flowing around the system that consumers will effectively bid up the prices of goods? My first observation would be that inflation linked to supply shocks tends to be associated with a reduction in spending power in real terms. The classic example is higher gasoline prices leads to less consumption elsewhere. Now, that's an extremely well-traveled analytical path. The greater unknown is what about all this money that's sloshing around in the system at this point, why might that not lead to higher prices?

Ben Jeffery:

Have you seen the S & P 500?

Ian Lyngen:

Do you mean all the way up there…? But anyway, that actually brings me to another aspect of inflation and that is, can the Fed sustainably create true demand side inflation on the consumer price front, or will they be content with a repeat of the 2010 to 2019 experience where the best that they could do consistently was to contribute to asset price inflation? Now, there will always be talk about bubbles and about story stocks that might lead to contagion and ultimately undermine the financial system. But as the Fed has pointed out, that's not the primary focus of monetary policy makers at this moment.

Ben Jeffery:

And another facet of all this money in the system that's worth discussing is the implication for household balance sheets and a higher savings rate that's resulted from all of the events that have transpired over the past year. So before we're able to really see the true demand-driven type of inflation that the Fed is after, what ultimately will need to happen is upward pressure on wages and upward pressure on real wages that comes along with higher consumer confidence and thus a willingness to spend.

Ben Jeffery:

There is some argument to be made that now that administered first doses exceed total case counts in the U.S., that's some pandemic-related optimism not pessimism may begin to make its way in the system. But this is surely going to be a space to watch as presumably vaccination rates pick up with a greater variety of inoculations presumably receiving approval in the coming weeks and months.

Ian Lyngen:

One quick observation as we talk about the progress toward the new normal and how long it will be before the restrictions are completely removed, something that strikes me is we spent a lot of time talking about how long before we get there, but we really have no idea what there will be like. We really have no idea how many of the changes that we have seen in the patterns of consumption during the pandemic will be permanent, or at least semi-permanent as we transition forward to 2022, 23 and beyond.

Ian Lyngen:

There certainly is a camp that believes that we're going back to 2019 in very short order. I'm more than a little bit skeptical of that, simply because of how willing both employers and employees have been to embrace the work from home reality and the implications that that will have for frontline service sector businesses, particularly in previously high-population density areas that have suffered the most during the pandemic as people have moved out to the first and second ring suburbs or beyond.

Ben Jeffery:

So, what you're saying is we'll know when we get there?

Ian Lyngen:

Probably know when we've passed it.

Ian Lyngen:

In the week ahead the Treasury market will have two primary macro-events to digest. The first will be the January core inflation report with a consensus of two tenths of a percent month over month. This will be accompanied by a overall read on consumer prices with headline CPI seen at plus four tenths of a percent. The other major event will be the February refunding auctions. We have threes on Tuesday at $58 billion, we have tens on Wednesday at $41 billion, and that's rounded out by Thursday's $27 billion long bonds.

Ian Lyngen:

Unlike the 10-year sector where there has been some pushback as yields edge ever higher, in thirties the long bond has been able to push through some of the prior yield peaks that were established early in the year and continue to drift closer to 2%. Now in an environment where the primary narrative is that of reflation, this week will offer a near-term litmus test. Now, we continue to emphasize the difference between near-term inflation that's realized in the data and expectations for forward inflation, but in the very near-term this dynamic will be a tradable event.

Ian Lyngen:

So we'll be watching for the market's willingness to push 30-year yields even higher in part as an auction concession and part as a reflection of the assumption that we will at some point be faced with higher consumer prices that warrant the return of term premium or at less negative term premium at least, as the Fed continues with its effort to change investors' understanding of the Fed's relationship with inflation going forward. Recall last year shift in the framework to a year over year core inflation target, that is a transition that has come with a certain degree of credibility risk for the Fed.

Ian Lyngen:

By this by simply mean that the Fed has committed to keeping rates lower for longer. Even if we see the type of inflation that historically the Fed might have responded to, it will be that moment in which the Fed's credibility is really brought into question. And the outcome in which the Fed retains credibility is by not acting, and that speaks to a steeper curve and higher rates further out, particularly in the third year sector. This dynamic will presumably come into focus this week as we have the combination of an update on inflation as well as supply considerations.

Ian Lyngen:

All that being said, we're confident that the underwriting process of the Federal deficit will continue, we don't anticipate any significant tails at the auctions nor any true price dislocations that would get the Treasury Department concerned about the amount of supply that's currently hitting the market. Our primary concern on the supply front does remain a crowding out of other fixed income investments, particularly when it comes to higher-rated or comparable alternatives to Treasuries. The question quickly becomes if you can get 10-year yields closer to 1.25%, where's the value in the relatively small pickup to go further out the credit curve even if the alternatives are truly of comparable credit quality?

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. Even though Phil saw his shadow this week, the weather is still the same indoors as we wait to see if Brady's Bunch will take home the rings this weekend, or if Muddy Waters had it right with going to Kansas City again.

Ian Lyngen:

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