

My Punny Valentine - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons Episode 107: My Punny Valentine, 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 16th. And with Presidents' Day on the horizon, we're looking forward to once a year discounts on mattresses, new cars and old strategy.

Speaker 3:

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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 data points from which to refine forward expectations. The most relevant one on the economic data front was the disappointing core CPI print for the month of January. In January, core consumer prices were effectively flat. This included the second consecutive month over month drop in auto prices. Now this is relevant, because part of our core thesis for 2021 was that part of the upside that we saw in the realized inflation data during 2020, had to do with a pandemic-driven rotation out of the densely populated urban centers into the first and second ring suburbs.

Ian Lyngen:

That shift is evident in the data, particularly on the housing side, but it also intuitively brings with it demand for new and used autos. We saw that as a key contributor to the upside in inflation during the second part of 2020. And the question now quickly becomes, will that be sustainable as this year plays out as one of the typical indicators of true demand-side inflation, we will be watching Otto prices very closely. In addition, the Treasury market had to contend with the refunding auctions that was \$58 billion in threes, which stopped through two tenths of basis point, \$41 billion in new tens, which stopped through three tenths of a basis point and \$27 billion in thirties, which tailed one basis point. Now one might be tempted to interpret the results of the long bond auction as a sign of a lack of sponsorship for Treasuries further out the curve.

Ian Lyngen:

However, refunding 30s, not re-openings have a very strong tendency to tail, having done so now at 9 of the last 11 refunding auctions. This leaves us reluctant to interpret those results as anything more than strong, ongoing sponsorship for duration in the Treasury market. Now, the price action came close to conforming with the typical pattern of pricing in an auction concession ahead of the event. But instead

of that occurring in the week of the auctions themselves, the biggest concession was priced in a week before and the market managed to effectively bull flatten throughout most of the refunding. Friday's price action was the notable exception however. We saw upward pressure on rates with very little on the data calendar and really no underlying motivations for the price action aside from a position squaring ahead of a long weekend, given the relative success of the auctions, and investor's willingness to engage in at least an initial round of dip buying. Wasn't surprising to see some profit taking and position squaring ahead of the long weekend.

Ben Jeffery:

So we had refunding auctions, no inflation, a rally in Treasuries, and then a move higher in rates. What's going on?

Ian Lyngen:

We have seen a range-confirming series of events and the subsequent price action. Now with 10-year yields drifting back toward that 1.20 Level, it's easy to look at 1.25 as the next key support. The thing that I would caution against however, is assuming that a break on no information with simply a sideways shuffle in rates as the prevailing theme, doesn't carry the same weight as had this been a wholesale repricing based on economic data or a supply event. In fact, I was impressed with how well the market was able to take down the 10 and 30-year auctions without much of a concession on the week. That said, we did have the prior week's run up in rates to set the stage for the first new 10- and 30-year offerings of 2021.

Ben Jeffery:

That's really critical context and framing the setup that we saw for both tens and thirties, while the moves going into the auction were dissimilar from January and that the intraday setup for supply was hardly intuitive. Yields were at the lows of the day for both tens and thirties. The fact that in outright level terms, the only time we've seen higher outright rates was last week and the time around the January reopening auctions. So sure, there wasn't that textbook sell off into supply and rally out of it, but from a broader context, yields are still effectively higher than they have been throughout the entirety of the pandemic. So from that perspective, it makes sense that we saw decent sponsorship for tens less so for thirties, but still a well bid auction, regardless.

Ian Lyngen:

But we also within the details of the bidding for the 10-year sector, saw an above average direct bid. Now we don't have the bitter breakdown detail yet, but that tends to be associated with domestic interest more so than overseas bidding. So I'm comfortable in suggesting that if nothing else, we learn that there's a potential for reasonable domestic sponsorship for 10-year yields above 1.15. Now whether or not that translates through to the establishment of a new upper bound for 10-year rates at 1.20 remains to be seen. We've been focused on what from a technical perspective appears to be a double top. And that's a double top between 1.19 and 1.20, not textbook, but close enough that it suggests the current period of consolidation might ultimately resolve in lower rates.

Ben Jeffery:

And the second of this week's highlights, which was the January CPI data also lends itself to a period in this current zone. We saw a flat month over month read in core CPI, which brought the year over year pace to its lowest level since June. Now we often talk about the distinction between realized inflation

and inflation expectations. And one data point is hardly indicative of the broader trajectory, but nonetheless, for those in the surging reflationary camp, the January data was certainly discouraging and the knee-jerk rally in ten year yields immediately following the release add some credence to the notion that the fundamentals are not being entirely ignored by the Treasury market, even if discounted somewhat given the fact we are still in the midst of the pandemic.

Ian Lyngen:

And to your point, it's different to see the Treasury market trading off of inflation at this point in the cycle. Than for example, trading off of the manufacturing sector data, or to a large extent ignoring for example, the employment report. Because the market's concern with inflation is so high as we come out of the pandemic, it does follow intuitively that there would be price action associated with the realized CPI data. While we've made this point in the past, I think it warrants reiterating that the distinction between realized inflation and inflation expectations and the divergence that we have seen thus far in 2021 is an important backdrop as we think about the market going forward. We could very easily see the real inflation data continue to struggle as the year plays out, but inflation expectations remain high. It's also important to keep in mind that headline CPI, for example, is heavily weighted toward the energy sector and gasoline prices. And with the front month WTI contract, well, North of \$50 a barrel at this point, one would expect that to be reflected in breakevens, especially in shorter dated too.

Ben Jeffery:

And the moves in the energy complex really adds some staying power to this rally we've seen in breakevens. Both five and 10-year breakevens are above 220 basis points. And while the underwhelming CPI read should on the margin detract somewhat from those expectations, the fact that we're seeing such a meaningful pickup in crude and gasoline prices really limits any potential downside should we see a reversal. Now that doesn't take some give back off the table, just considering how impressive the moves have been to begin this year, but it is a bit of a cross-market correlation to keep in mind in evaluating where it is exactly inflation expectations lie.

Ian Lyngen:

Another key distinction is between goods inflation and service inflation. Given that the consumption patterns created during the pandemic have favored goods consumption over service consumption, it makes sense that there was upward pressure on goods prices where flagging service sector inflation became the norm. Fast forward to the second half of 2021, once the economy is reopened and re-engaged in in-person commerce, the baseline assumption for market participants at this point is that we ultimately will see more upward pressure on service sector consumption and inflation to follow. When we think about the specific pockets where that might occur, we can't ignore the base effects that are going to hit the market in March, April, and May. Airfares will be a focus, apparel prices will be a focus, essentially everything that was hit at the beginning of the pandemic should be expected to rebound at some point. The question is whether or not that some point is in this calendar year or next.

Ben Jeffery:

And that's a good segue to the week ahead's data highlight, which is January's retail sales data.

Ian Lyngen:

Wait, you mean it's not the release of the December TIC data?

Ben Jeffery:

As surprising as it is to say, my attention at least will be focused on which sub-components of retail sales have been able to get off to a strong start in the new year. We've been looking at the non necessity sub-components of retail sales, which excludes things like grocery stores, gas stations, pharmacies, et cetera. And what's been very notable is the speed with which those non-necessity sales have recovered from their initial plunge back in March and April. During the last recession, it took over five years for that measure of discretionary spending to recover to the level it was before the global financial crisis. So on the margin, the bouncing non-necessity sales out of this recession has been an encouraging indication for consumption.

Ian Lyngen:

With the caveat there that this is primarily goods consumption, because in the context of how the real GDP numbers are compiled, we look to the retail sales sub-component of the control group as the primary input for good spending. And then, it's not until we get the personal income and spending data in the PCE report that we'll have a better sense of the overall consumption profile. So a strong number on Wednesday, very consistent with this idea that goods spending hasn't been unduly impacted by the winter wave of COVID-19 even after the disappointing December spending data that was attributed to the winter wave of the pandemic.

Ben Jeffery:

And outside of retail sales, I guess aside from the 20-year auction, it's probably going to be a week where the price action itself garners a lot of focus. From a technical perspective, we've seen rates move right up against that support level that you touched on earlier Ian, with the momentum landscape now bullish. So the willingness of investors to push or consolidate the move at these levels will help inform the latest technical parameters to be mindful of as we continue the process of vaccinations and hopefully the data gains relevance in determining the moves in U.S. rates.

Ian Lyngen:

One of the background macro-factors in the market at the moment is the ongoing progress towards stimulus. Now, as it currently stands, expectations are for some type of tangible progress by the end of February. Now, we all know that the political process in and of itself tends to be characterized by delays and 11th hour negotiations. So wouldn't be too surprised to see the timeline ultimately extended into March.

Ben Jeffery:

And on that topic, it's once again worth highlighting the results to our pre-NFP survey, which revealed a consensus around market expectations for the ultimate size of the fiscal deal. The most common response was between \$1 and \$1.25 trillion. But just as interesting, was the fact that no one thought no deal was going to come and no one thought a deal below \$500 billion was going to come. So this suggests that a critical facet of the current market landscape is the anticipation that a fiscal deal, at least in the neighborhood of \$1 trillion will be signed into law in the not too distant future.

Ian Lyngen:

One of the questions that we've received several times over the course of the last couple of weeks is just how much will the 10-year yield respond to a stimulus deal when it's finally announced. So, using that one to \$1.25 trillion consensus, anything either materially above or below that, will trigger a price

response in the Treasury market. Otherwise, I suspect that once we finally get a deal, the Treasury market will be very content to move on to trading the broader macro-influences once again, with perhaps an eye on domestic data, all of which being overshadowed by the drive toward herd immunity.

Ben Jeffery:

And this past week saw a milestone on that trip to herd immunity. 34 million people domestically have received at least one dose of the coronavirus vaccine, which is one out of 10 people in the U.S.. Add to this the 25 million confirmed COVID cases. That brings us to nearly one in five people that have at least some form of resistance against the virus.

Ian Lyngen:

So the take away is, what pandemic?

Ben Jeffery:

Oh, you know, the one that just changed society, financial markets, economic theory... you know that one?

Ian Lyngen:

Well, I never got out much anyway.

Ian Lyngen:

In the week ahead, the Treasury market has a variety of inputs to deal with, not least of which being retail sales. Now retail sales is going to be a key determinant in the overall direction of expectations for the recovery. On the one hand, throughout the pandemic, we have seen a transition from service consumption to goods consumption. And as we've discussed, that has implications for pricing. What remains to be seen is just how significant a dampening impact the winter wave of the coronavirus has had on consumption. Also, be looking in the details for any evidence of expansion into certain categories, not least of which being dining bars, restaurants, et cetera. We'll also get the FOMC minutes. And the FOMC minutes are expected to shed some light on the topic of the potential for a fine-tuning adjustment, slightly higher in front end rates. And given all the chatter associated with the Treasury Department's cash balance and Yellen's plans to term out borrowing further out the curve at the expense of bills and will be an important discussion point, if nothing else.

Ian Lyngen:

Let us not forget, we also do have the 20-year auction. That's \$27 billion in paper, further out the curve. Now it's not as pivotal as the 10 and 30-year auctions, although it is an important benchmark in the context of deliverables for the classic bond contracts. So there should be a natural buying base that absorbs that liquidity relatively seamlessly. We'll also see 30-year TIPS. That's a new issue of 9 billion on Thursday. Now real yields are very negative, certainly in a historic context. And so, it will be useful to have the 30-year TIPS auction as an indicator for investors' willingness to continue to pay up for inflation protection, especially given the 30-year time span of that particular bond. In addition to these macro-factors, we'll also be very eager to see how some of the sentiment gauges play out.

Ian Lyngen:

We did see a rolling over of stochastics with a full cross now favoring lower rates, particularly in tens and thirties, but that moment was followed by upward pressure on rates into the long weekend. We're continuing to attribute that to simply position squaring, profit taking, post-refunding and an unwillingness to carry any significant positions into the long weekend. 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 Cupid prepares to make the rounds, we're reminded that there's really nothing more endearing than the commercialization of a holiday about romance.

Ian Lyngen:

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