Riding on Perseverance - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 108, Riding on Perseverance, presented by BMO Capital Markets. I'm your host, Ian Lyngen, and here with Ben Jeffrey to bring you our thoughts from the trading desk for the upcoming week of February 22nd. And with NASA's latest rover landing on Mars, echos War of the Worlds are hard to ignore, HG Wells, not Tom Cruise.

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 had a fair amount of fundamental and flow information to digest. The biggest economic data was the stronger than expected retail sales print. Now it was a very impressive above 5% monthly gain in January for headline retail sales. However, it is important to keep in mind that that number was strongly influenced by stimulus checks and therefore is unlikely to be repeated in February and March.

Ian Lyngen:

Nonetheless, it did lead to upward revisions for GDP estimates for the first quarter, which does put the beginning of 2021 on reasonably strong footing. Now, for context, the growth won't be comparable to what we saw in the third quarter of 2020 when the economy reopened, et cetera. But nonetheless, a solid trajectory as the year gets underway will help provide an ongoing bearish underpinning and the Treasury market. Now we are talking in the context of 10 year yields above 125 while still below 150 so we're cautious against assuming that we are entering a period where there would be a wholesale repricing to a sustainably higher rate plateau. Moreover, we're also in what has historically been one of the most bearish periods of the calendar. The first quarter economic optimism is running high, upward pressure on inflation expectations as well. This year, the Treasury Market is faced with $1.8 trillion in net new issuance, which combines well with the narrative of higher rates particularly further out the curve.

Ian Lyngen:

We can see that in the current environment, the front end is extremely well anchored to monetary policy expectations. And in fact, two year yields continue to drift lower and lower with the 10 basis point level quickly approaching. Now, part of this has to do with the Treasury Department's significant Fed balances, that $1.6 trillion number that has been thrown around, and expectations that Yellen will make significant efforts to run those balances down, thereby putting more liquidity into the system with an emphasis on the front end of the market. So all of that cash in the front end chasing a yields lower will continue to be thematic. That will also put upward pressure on the shape of the yield curve. Twos tens got as steep as 137 basis points in December 2016. And we're comfortable using that as a guide for the first target of steepening in the event that the selloff continues in Treasuries.

Ian Lyngen:

So that puts 10-year yields at a 148 to 151 range. It goes without saying that the market loves a round numbers so 150 as a target will certainly have a fair amount of sponsorship, but before we get there, the response of risk assets will continue to be influential in estimating just how far this bearish price action can run. Another characteristic of the week just passed was while we did have retail sales, it was ultimately the price action itself that became both the story and the trigger. By this, I simply mean that the magnitude of the sell-off in rates became topical. And with our continued focus on the feedback between higher yields and lofty equity valuations in the US, we anticipate that investors will be watching very closely for any signs of wobbles in the equity market.

Ben Jeffery:

So we got 10-year yields above 130, but equities seem to be doing okay, at least for now.

Ian Lyngen:

Yeah. I think that's one of the key risks at this point in the cycle is that a backup in rates eventually translates through to wobbles in the equity market. Now, as you point out, we have yet to see that, but that doesn't mean that such price action won't ultimately occur. One of my current concerns is that we find ourselves in a situation where 10-year yields are ranging between 130 and, let's call it, 145, long enough that there's eventually a reckoning in the equity market because the move is viewed as sustainable more than just a one-off. At the moment, I would argue that what is keeping equity valuations high is the assumption that this is just a temporary spike in rates. And if it gets bad enough, the Fed will get involved.

Ben Jeffery:

And I'll borrow a point you make often, Ian, which is that, should we see any material weakness in the stock market, the pace of any decline matters. A steady drift lowers say over the period of a few months is not going to elicit the same reaction as say a 10% or 15% plunge in a matter of days or a matter of weeks. And this emphasizes the importance of the VIX to broader financial conditions, which ultimately is the input that the Fed is monitoring. So a decline in risk asset valuations will not necessarily trigger a Fed response, but a sharp drop in them certainly could.

Ian Lyngen:

And that's certainly not uncharted territory for this market. We saw a quick correction in 2020, and even before that, equities started to wobble in 2018 when 10 year yields moved above 3%. One of the primary questions in the market at this moment is just how sustainable is this back-up in rates. There are two camps that continue. The first camp being our thesis which is that we're redefining the upper bounds for the trading range, and eventually when we get more macro inputs over the course of the year, we'll see the seasonal patterns take hold and a recalibration lower in the outright level of rates. Now it goes without saying simultaneously as the upper bound for the range increases, so should the bottom bound. So it would be difficult in this environment to imagine 10-year yields south of 75 basis points, but a dip below 1% certainly is not off the table.

Ben Jeffery:

And there was a really strong piece of evidence that we saw this past week on Wednesday, which was a combination of events that should have translated to a break of that 133 level. And that was a resoundingly strong retail sales print for January that showed a 6% month over month gain in the control group. Definitely a good indication on consumption for the first quarter, but the fact that that data really went almost completely ignored by the Treasury Market, supports this idea of a reluctance to push the bearishness much further even with some fundamental information in hand that would otherwise warrant higher rates. To me this points to a great deal of the optimism being brought into 2021 assuming the realized data would catch up with that optimism. So from that perspective, rates roughly in this current zone make sense.

Ian Lyngen:

I'd offer the caveat that the stimulus checks had a big impact on retail sales in the month of January. And so part of the market's reluctance might be, yes, we were looking for data to justify the backup in rates, and this did provide some confirmation, but also we can say with a straight face that we're not going to have another 5.3% month over month gain in headline retail sales during the first quarter.

Ben Jeffery:

And it wasn't all good news on the data front this past week. And I'm referring to jobless claims here, which reach a four week hide during the NFP survey period. There was effectively no knee-jerk market reaction, but the fact that further declines in jobless claims are increasingly difficult to envision really highlights that the last jobs brought back are going to be the most difficult to achieve. This stabilization and initial jobless claims North of 700,000 is not a good indication for the pace of hiring and ultimately the wage pressures that one would like to see at this point in the recovery.

Ian Lyngen:

And the recent rise in jobless claims also reminds us of one of the core concerns that we have as the recovery gets underway, and that is the depressed participation rate. The number of sideline workers continues to be problematic, and it also will presumably put downward pressure on wages once we're further into recovery and more displaced workers are brought back in. Shifting gears slightly, Ben, we just had two tailed auctions with pretty significant size. The 20 year tailed 2.1 basis points. And the 30 year tips tailed 3.7 basis points that's in stark contrast to the relatively strong reception that we had to the February refunding. What do you make of this dynamic?

Ben Jeffery:

This is actually a perfect example of what will probably continue to be thematic throughout this year regarding what's going to be record large net issuance. And what I mean by that is around the supply events themselves such large auctions can absolutely elicit price action. The 20 year this past week was an excellent example and looking historically it's the new issue, aka larger auctions, that typically tail whereas reopenings show a bit stronger auction sponsorship. Now in this context, a 2.1 basis point tail for 20s hardly resets the outright level of rates, but it does represent the discount that was required in order for the Treasury Department to issue the entirety of the bonds. As for 30 year tips, there's probably less of a broader market takeaway just given that part of the Treasury Market and all the liquidity nuances that apply there. And versus the last 30 year tips auction, which was in August 2020, which tailed 5.6 basis points, the 3.7 basis point tail really could be chocked up as decent, if not great.

Ian Lyngen:

So what you're saying is that the demand for inflation protection for the next 30 years is not waning? Given everything that has gone on thus far in 2021. It's also remarkable that the nominal market rallied into the 20 year, the 20 year tailed, and we didn't see a material reversal of the direction of rates. Now admittedly yields are still towards the upper end of the range, but the market's relative indifference toward the performance of the 20 year, I think, reinforces this notion that while supplied does matter for curve shape and the potential for tactical concessions, it isn't going to wholesale redefine the rates complex.

Ben Jeffery:

And pulling that logic forward to the week ahead, we do have twos, fives, and sevens as well as month end duration needs to consider. Given the impressive steepening that we've seen in the curve over the past several weeks, a degree of flattening give-back would certainly mesh a greater required concession for twos, fives, and sevens, as well as any position squaring that might be required before March gets underway.

Ian Lyngen:

One of the questions that we've fielded several times over the course of the week is just how far can 10-year yields backup before something gives. Recall that during the last interest rates cycle, when the Fed was actively normalizing rates, the mantra appeared to be that the Fed was going to continue hiking rates until something broke. And it's exactly what they did. We saw that via the correction in risk assets that we referenced earlier, mapping that same paradigm on today's price action, the question becomes how long will the Fed stay sidelined in the face of incrementally higher rates?

Ian Lyngen:

We'll argue that the methodology for estimating a good target in this current environment is simply to look at the curve shape during the prior cycle. So using this logic in December 2016 twos tens got as steep as 137. In today's environment that would advocate for targeting 10 year yields at 148 to 151. That's a pretty significant move from where we are now. And I suspect that it would be a challenge to gain those last 10 to 15 basis points to achieve that target. And to the Fed point, I think it's also safe to assume that that would be a level at which they would start to get somewhat nervous, even if we didn't see that correction in domestic equities.

Ben Jeffery:

Ian, in that environment, what do you make of the argument that if the real economy starts to perform in such a way that we start to see a sizable pickup in long end yields that does not come at the expense of domestic equities that may be, dare I say, tapering hike expectations start to get pulled forward versus where they sit currently.

Ian Lyngen:

You make a great point. The eurodollar curve at this moment suggests that the market is thinking that 2023 is the year that tightening commences. For us to envision a 10 year yield above 150 or a five-year yield closer to 75 basis points, let's call it, we would need to accelerate rate hike expectations. And I struggle to see an environment in which the Fed wouldn't push back against that, because recall the Fed is actively in the process of trying to redefine investors' understanding of the way that they'll respond to inflation going forward. So not only will we need to see a period where inflation runs hot, but we'll also need to see that same period accompanied by a reluctant Fed. This is the Fed's big credibility gamble, and as we contemplate just how steep the curve can get and how far rates can back up, it's important to keep Powell's incentives in mind.

Ben Jeffery:

And that promises to be a theme that's touched on several times by the top tier Fed speak we received this week. Powell heads to virtual Capitol Hill for his Humphrey-Hawkins testimony. We hear from Vice Chair Clarida and New York Fed President Williams. All of whom will almost certainly reaffirm that QE is going to stay in place at at least its current pace until the end of 2021. And that it's far too soon to even begin thinking about the discussion around normalization. So bringing it back to your point on the shape of the curve, Ian, it's very reasonable to anticipate that two year yields are going to be in that 10 to 15 basis point range for the foreseeable future even if we do start to see a meaningful pickup in inflation simply to affirm the Fed's credibility.

Ian Lyngen:

So, Ben, Powell is going to be there virtually live?

Ben Jeffery:

Yes. I do assume he will be there live and not a cat.

Ian Lyngen:

In the week ahead, US rates will have a variety of fundamental inputs, including Friday's core PCE numbers. Recall that the January core CPI disappointed, and as we project forward to what one might anticipate on the core PCE inflation measure, it's difficult to skew anything higher than the 1/10th of a percent consensus. Powell will also be giving his semi-annual congressional testimony, and this will provide a forum for the chair to reinforce the notion that the Fed will continue to provide ample accommodation at this point in the cycle to promote the recovery as the progression out of the pandemic continues.

Ian Lyngen:

The current pace of vaccinations combined with estimates for an acceleration suggest that by this summer the US economy will be functioning a lot more like normal than it has since the pandemic took hold. In terms of specifics to anticipate from Powell, any commentary on the pace or composition of bond buying will certainly be noticed by the market although it's a challenge to imagine that Powell will take this opportunity to deviate from the very consistent message that QE in its current composition and at the current pace will remain in place through the end of 2021.

Ian Lyngen:

Now we could envision a discussion taking place about the tapering of QE, but that discussion in the public forum is very unlikely to become a reality until the very end of 2021, if not the beginning of 2022. Both the Fed and market participants remember very well the 2013 taper tantrum episode, and monetary policy officials will strive to avoid repeating that mistake. A question we often get is what is tapering worth in 10 year yields? Is it a 75 basis point event? Is it 50 basis points? Is it something even less? Our take is that the prospects for a true taper tantrum comparable to what we saw in 2013 are very low.

Ian Lyngen:

First of all, the Fed certainly learned its lesson, but more importantly, the continued strides towards transparency are tangible. And so by the time the Fed makes it clear that they intend to taper, the groundwork for the decision-making will be well-established. And for that reason, I suspect that the actual tapering in this cycle will not have a dramatic impact in the Treasury Market. Said differently, by the time the Fed is willing to start the discussion on tapering, the economic data will be strong, inflation will be coming back, and the Treasury Market will have already priced in off of those macro influences the progression to the next part of the monetary policy cycle. So in essence, the Fed will allow the market to tighten financial conditions for it, and then eventually follow through with the change in monetary policy. 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 between raging kitty cat filters, and Joe exotic. We're truly thankful for the year of the ox.

Ian Lyngen:

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