Bond Ides of March - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons Episode 109, Bond Ides of March, 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 March 1st. And we're reminded that despite the struggles of celebrity marriages, there's always 2024, Kanye.

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:

The week just past in the Treasury market was a very pivotal one. We got the backup in yields that we had been anticipating with the target of 148 to 151 in 10 year yields achieved, the market pressed a little bit beyond there, but we have managed to stabilize somewhere slightly below 150. Now 150 has some clear and obvious psychological significance, the market does love round numbers, but the fact of the matter is this move has a slightly different character than what we saw earlier in the year.

Ian Lyngen:

Earlier in the year, the narrative was driven by inflation expectations. We saw that in break even space with real yields effectively unchanged at roughly negative 100 basis points in the 10 year space. What has occurred over the course of the last week and a half has been an increase of almost 40 basis points in real rates. And that price action has affectively served to tighten policy while the Fed is actively easing. And as a result, we are entering a phase where we've started to hear from global central bankers, the ECB in particular, that they're getting a bit nervous about the extent of the sell-off, and the potential for the rise in real rates to undermine risk assets, and to undermine the outlook going forward.

Ian Lyngen:

Now we're still in the process of progressing from the mid-pandemic to the post-pandemic stage of the recovery, so there's a great deal of uncertainty that remains embedded in the economic outlook.

Ian Lyngen:

The week also saw the beginnings of what could be more significant wobbles in the equity market. Now an occasional 2, 3% down day for stocks isn't going to trigger the type of increase in equity volatility that ultimately leads through to tighter financial conditions. However, the Fed is in a difficult position, because if they remain sidelined and don't at least contribute to the conversation of caution against this recent backup in rates, it will be reasonable to interpret that as a green light for even higher yields. Imagine a situation in which we are faced with 175 bp or 2% 10 year rates. That will undermine global equities even further and that's where we get that five, 10, 15, 20% correction in equities that the Fed will then appear to be behind the curve on, rather than managing to forward financial conditions expectations as they have throughout much of the pandemic thus far.

Ian Lyngen:

There's also little question that the uninspired takedown of the five year and the record large tail for the seven year, the $62 billion auction, has provided some evidence for the bond vigilantes. Now we maintain that won't be supply itself that gets the market to reprice to a higher plateau. However, it is difficult to argue with the lack of sponsorship for the seven year auction at a moment when the market was actively repricing to a new macro narrative.

Ben Jeffery:

So Ian, it's a pretty rare when we start our conversations talking about a seven year auction, but I think we have to.

Ian Lyngen:

Yeah, I think seven year auctions are one of the benchmarks that typically comes and goes and has very little influence on the Treasury market. Now to be fair, the price action over the course of the last couple of weeks has been about much more than supply. However, it was the results of the seven year auction that really catalyzed the bearish price action that was already in place.

Ben Jeffery:

And it was very interesting to see the fact that despite what could otherwise be considered a very healthy intraday concession for the new bonds, the speed of the move going into the auction that brought 10 year yields beyond 160 basis points really translated to some primary market participants simply not being willing to get in the way of the sell-off. That's why we saw the largest tail for a seven year auction on record, the lowest bid to cover for a seven year auction on record, and the lowest non-dealer take-down since September, 2014.

Ian Lyngen:

Well, there's also something else at play that I think is worth acknowledging, the bulk of the backup and rates intel this week had primarily been a reflationary trade. So we saw that play out with higher 10 year break evens, up against 225 at one point, although they've stabilized a bit lower from that. And that's certainly consistent with one of the major risks for this point in the cycle. But what has occurred is the market has transitioned from pricing in greater term premium and a steeper curve to an emphasis on the timing of the Fed's liftoff. And we can see this in the Euro dollars market where now the December 2022 contract has a hike fully priced in. I'll make the argument that that's far too aggressive, given the struggles that the Fed had winding down its last QE program.

Ben Jeffery:

I completely agree. I mean, we're still in a world where the Fed is expanding its balance sheet at $120 billion a month. Across the board we've heard from Fed speakers that it's far too early to even start the conversation about when tapering bond purchases might be appropriate, and using the order of monetary policy operations from last cycle, if the dialogue around tapering has not yet commenced, isn't it far too soon to be contemplating rates off the effective lower bound?

Ian Lyngen:

Realistically speaking, the Fed would need at least six to nine months to wind down its bond buying program. And they've already committed to keeping QE in place into the end of 2021. So this implies that if all goes according to plan, which does have a fair degree of optimism built into it, we'll see the Fed's last balance sheet expanding purchase of Treasuries occur in the second half of 2022. It would be very atypical for the Fed to quickly then shift to hiking rates, especially in light of the Fed's behavior between 2013 and 2015.

Ben Jeffery:

And remember back in that instance, even after Yellen's first hike, it took a full year for the committee to execute their second one. So the fact that the outlook on the recovery and monetary policy is an issue that it will be important to be mindful of as the March 17th Fed meeting approaches and given the schedule with the Fed speak we have during this upcoming week. Powell is now scheduled to give a speech on Thursday and it will be very topical to see how he addresses these developments and if he sticks with what has been the party line of a comfort with higher rates, or starts to walk back to that theme somewhat.

Ian Lyngen:

Well, I could envision him walking that theme back by focusing on real yields rather than nominal yields. If we look at the 35 basis point backup in 10 year real yields, it's very clear that this is the type of move that should get monetary policy makers nervous. Now we've heard from several ECB officials that they're monitoring the backup in real yields. And if we see a comparable tone shift from the Fed, that speaks to the notion that the Fed might be more willing to get involved in terms of altering the composition of the current bond buying program.

Ian Lyngen:

It will also serve as important signaling for investors who have started to view good news as bad, as it were. So when we get strong economic data, it reduces the urgency on the part of lawmakers to deliver fiscal bailout 3.0. Now we've seen some of that play out in the equity market, although a key part of what's playing out in equities at the moment has to do with the tech sector responding to higher yields.

Ben Jeffery:

And in thinking about what sectors performed the best during the pandemic, tech comes to mind. So if in fact the journey toward herd immunity is progressing faster than expected, and a return to some version of normal may be closer on the horizon than initially expected, then maybe it is a little bit reasonable to expect some of those notable outperformers to retrace to a degree, to say nothing of the influence of higher borrowing costs on some of these firms.

Ian Lyngen:

I'm very cognizant of the "this time it's different" arguments that really revolve around the fact that this massive recession has been caused by a global pandemic. There's an approved vaccine that is being distributed throughout the world with the goal of herd immunity. And once we transition back to commerce as usual, that that should lead to a roaring rebound in the global economy. It's difficult not to question some of those assumptions, however, because all the stimulus that's been going into the system doesn't have the same implication that prior stimulus has had. And by this, I simply mean when the economy is fully functioning and you roll out transfer payments of 600, 700, $800 billion to the economy, you'd expect that money to be used for consumption.

Ian Lyngen:

In this environment, however, what we see, and this is evidenced by the very high savings rate is that the subset of the labor force that was hardest hit by the pandemic is effectively living stimulus check to stimulus check. And so, unlike adding to disposable income, the stimulus efforts have simply created a financial bridge to get that sector of the labor force through to the point where those jobs are once again available in the economy. My concern is that herd immunity does not imply that those jobs are immediately going to come back.

Ian Lyngen:

In fact, the willingness on the part of roughly 25% of the economy to work remotely, and the broader implications from that, suggests that the transition to the new normal is going to take longer than simply the span of 2021.

Ben Jeffery:

And this brings up a great conversation I had with a client this week regarding the massive amount of optimism that's made its way into the Treasury market. And the discussion really focused on exactly the dynamic that you're talking about, Ian. So far, what consumption we have seen, has been principally a function of largesse from Washington. The fact of the matter is there are still 10 million fewer jobs now than there were when we entered the pandemic. In an environment where there's still unquestionably a large degree of slack in the labor market, it's going to be very difficult to see sustained upward pressure on wages, which ultimately will flow through to the quote unquote true type of consumption that the Fed would ultimately like to see. This is a theme that promises to persist and the latest update on the state of the labor market via February's jobs numbers will be closely watched in Friday's BLS print.

Ian Lyngen:

I'll be keeping an eye on labor market participation as well as average hourly earnings. The consensus is for a two tenths of a percent increase in average hourly earnings, although watching the composition of labor will be key, because if we continue to see struggles for the low skill, low wage earning sector, that will create natural upward pressure on average hourly earnings, simply because those jobs won't factor into the equation.

Ben Jeffery:

Bringing it back just a bit to the price action itself. We had had an initial bearish target of that 148 to 151 zone in 10 year yields. That's now been traded and breached for a short time. Going into this highly consequential week for Treasuries, is the bias here for a bit of a period of consolidation, an extension of the sell-off, or maybe more substantial dip buying?

Ian Lyngen:

That is the operative question. Are we witnessing the beginning of a move that will get 10 yields to 2%, two and a half? Or are we seeing the traditional seasonal patterns play out where we have upward pressure on rates at the beginning of the year, as green shoots and reflationary optimism is priced in, only to be met with the realities of the economic data cycle, thereby creating a cap for rates, as we see a drift lower throughout the summer? That's my base case scenario, but it is a unique cycle, and as a result of the course of the next week, I think that the right trade is to be sidelined with the understanding that while one might miss the first seven to 10 basis points of the next big move, prudence in selling weakness or chasing a rally is difficult to overstate.

Ben Jeffery:

And throughout the pandemic, the shape of the curve has been pretty much entirely a function of durations performance. But now that we've reached something of an inflection point where monetary policy expectations have changed and now we have some normalization reflected in pricing, it's not necessarily the case that the shape of fives 30s is purely a result of where 30 year yields are trending. So from that perspective, there could be some more nuanced trading opportunities presented in the shape of the curve, in the event, we do see the Fed start to push back on some of the bringing forward of rate hike expectations that we've witnessed over this past week.

Ian Lyngen:

So the takeaway from what you're saying is that there's a subset of the market that simply hasn't gotten the memo not to fight the Fed.

Ben Jeffery:

Maybe it got caught in the spam filter?

Ian Lyngen:

You mean like all of our research?

Ben Jeffery:

Exactly.

Ian Lyngen:

In the week ahead, the biggest challenge for the Treasury market will be figuring out whether or not the recent repricing is truly sustainable, or if investors are willing to push further into a territory of cheaper and steeper? A continued sell off in the long end of the curve beyond 150 in 10 year yields does necessitate bringing forward Fed rate hike expectations, and as such, that would imply that the next level of the move is going to be driven by the belly, particularly the five-year sector as the market builds in some assumption that this cycle will differ so dramatically from prior cycles that the Fed will be able to truncate tapering end of QE and the first rate hike into a period of less than 24 months.

Ian Lyngen:

We remain skeptical that that will come to fruition. Nonetheless, that is the trade that's currently underway. We do have a variety of Fed speak on the horizon and given the comments from the ECB and other non-Fed global central banking officials regarding the back-up in rates the market will be very attuned to any official commentary on the outright level of real yields, as well as the recent backup. Now, to be fair, 10 year tips yields are still at negative 65, 75 basis points, so it's not a situation where on a true, outright, level that this should be limiting. Rather it is the trajectory and the momentum that will have investors concerned.

Ian Lyngen:

It is jobs week. We have the February non-farm payroll print with a consensus of roughly 125, 130,000 jobs. Now, it has been a while since the Treasury market has actually traded off of the economic data. Unlike in the beginning of the pandemic, when investors were willing to dismiss the economic data as simply lacking context for the magnitudes of the moves, what we have seen now is the reliance on the assumption that there will be more stimulus coming out of Washington has led investors to effectively write off the first quarter. So regardless of how the labor market performs over the course of the next several months, the outlook for rates appears not to be impacted.

Ian Lyngen:

We're concerned that there will eventually be an inflection point when the data has just gotten so bad that macro expectations need to readjust, and our bias is that they will readjust to the downside. Now that isn't to imply that we are poised for another repeat of 2020 by any means. Rather that the path out of the pandemic and back to full recovery, so some version of growth seen in 2019, is not going to occur this year. Rather the runway needed for full recovery is much longer than the market is currently assuming.

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. With the Ides of March approaching, and the largest selloff in five years, we cannot help but ponder, et tu, Powell?

Ian Lyngen:

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