

## A Quarter to Remember - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 111, A Quarter To Remember, 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 15th. And as stimulus checks clear this weekend, we'll be the first to note that Treasury bonds on sale. Coincidence? We think not.

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, this 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](mailto: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, there were several key developments that will help inform market expectations going forward, particularly in the Treasury space. Most notably was that 10-year yields managed to make a new pandemic high breaking through that 1.62% level that we'd been focused on. This puts our target of 1.75 back on the table with an acknowledgement that we stepped back from that level, given the mid-week price action and the relatively strong take down of the ten-year reopening auction. That coupled with the disappointing core CPI print left us under the impression that 162 was as high as 10-year yields were going to get before the FOMC meeting. It was really Friday's price action that changed the tone.

Ian Lyngen:

Most specifically, we brought in weakness from the overnight session, despite any obvious catalyst. The economic data in the US on Friday did little to discourage the selling pressure, but it wasn't the true impetus. The repricing that is currently underway will characterize as the market pressing the "it" trade for 2021, which is the reflationary narrative. Now, as we've noted in the past, we can see realized inflation numbers continue to run relatively low while inflation expectations remain elevated. We suspect that that will be a key defining characteristic of 2021. That is a real economy that's struggling to produce true demand side core inflationary pressures despite reopening, and despite the stimulus, while market participants are content to continue pricing in inflation further out the curve.

Ian Lyngen:

Presumably at some point we will see a reckoning between expectations and realized inflation, but we do not foresee that in the first half of 2021. There's also been a lot of chatter about the SLR issue and the extension of the preferential treatment for Treasuries under this regulation. The Fed does technically have until the end of the month to extend this exemption, but as it appears now, the market

is trading on the assumption that it won't be extended, which has put upward pressure on yields and contributed to the re-steepening that has become so thematic. It is notable that midweek around the time of CPI and the 10-year reopening auction, we saw a shift in the trading dynamic in favor of the belly of the curve. So as investors started to rethink the prudence of bringing forward Fed liftoff expectations, we saw five and seven year yields drift lower.

Ian Lyngen:

The dynamic of the belly leading the curve was relatively new in trading over the course of the last three or four weeks. We started the year with tens and thirties being the dominant driver of either the bullish or bearish price action. And I suspect that we're returning to a period where Fed expectation will remain in place with the Fed on hold through 2022. And that will leave the curve shape and the bulk of the drama to play out in tens and thirties. Now, this is to some extent predicated on the notion that the Fed will keep their own projections relatively stable when they're published on Wednesday.

Ben Jeffery:

So last week we spent a fair amount of time talking about the prospects for 1.75, 10-year yields. Where do we stand on that?

Ian Lyngen:

Well, frankly, midweek, I started to question the chances we would actually see 10-year yields back up as far as 1.75. However, as we close out this week and the Friday afternoon bears appear to be regaining traction as it were. I do think that keeping that 1.75 level in 10-year yields as a target, either in the run-up to the Fed or in any bearish disappointment on the event itself does remain prudent.

Ben Jeffery:

And part of the dynamic that made 1.75 tens look at least a little bit less likely during this week just past, where the reopening auctions of tens and thirties. And for all the concern following the weakest ever seven year auction, really what was most notable about tens and thirties was just how average they were. We saw two smallish sales, but the bidding statistics were very consistent with the prior six month average. And really to me, what this pointed to is primary market liquidity coming at a point when yields had backed up. And that was enough to result in a very smooth, long end auction process.

Ian Lyngen:

There's been a fair amount of chatter regarding the recent drop in primary dealer holdings of Treasuries. I do think it's notable, but also warrants an acknowledgement to how the data itself is actually collected. What we saw was a record weekly decline in street holdings of Treasuries for the week of March 3rd. Now a good portion of that actually occurred in the Bill's market, but that's consistent with some of the dynamics that are playing out in the very front end of the curve. But it's also important to keep in mind that these figures are marked to market. So during a period where Treasuries are selling off, the market value of primary dealers holdings will by definition beyond the decline.

Ian Lyngen:

Now, while we have seen a meaningful reduction in terms of primary dealer holdings in Treasuries, it hasn't been the whole sale shedding of assets that one might be tempted to conclude based on a record decline in holdings.

Ben Jeffery:

And there's also a bit of a calendar factor at play. The exemption of Treasuries from the SLR calculation is still set to expire at the end of this month. That promises to be an area of focus around the upcoming FOMC meeting, even if it doesn't fall explicitly under the committee's purview. It's a Fed board decision. As monetary policy expectations are refined, the degree to which the Fed is willing to step back from some of the accommodation offered during the pandemic will be an area of focus. So it's not unreasonable to think that we may have seen some selling pressure from the dealer community, just in case that exemption is not extended in order to get balance sheets in order before the end of the month.

Ian Lyngen:

There are also a couple of interesting influential factors in the Treasury market worth noting. First, we've had a very disappointing core CPI number on Wednesday. The February pace of just one tenth of a percent, a month over month, brought the three month annualized number down to just 0.7%. This is relevant given the base effects that will come into play for inflation during March, April, and May. And the emphasis that the Fed will be sure to put on the three month annualized rate over what could be rather dramatic year over year changes. This implies that the departure point for the real time inflation gauges into this key period is going to be lower than one might have otherwise anticipated.

Ian Lyngen:

In fact, during the last three months, core CPI has either been 0 or 0.1, therefore not painting an incredibly reflationary picture at this moment. The other notable event was the ECB. The ECB came out and they made it very clear that it's their intention to accelerate bond purchases. Now whether that ultimately gets them to a higher number or is considered net stimulus is still open for debate. But the fact of the matter is that the ECB is unwilling to let the run-up in rates go on addressed. That puts some degree of on the Fed to either follow through or come up with a reasonable narrative why they don't need to.

Ben Jeffery:

I would argue a big part of the reason why the Fed feels they don't need to is the performance of inflation expectations. Somewhat in contrast to the disappointing realized numbers we've seen over the past several months, 10-year breakevens reached their highest level since early 2014 this past week. This can be readily attributed to ongoing optimism around the recovery. And there's also the now signed into law \$1.9 trillion stimulus package, as well as the announcement from the White House that by May 1st, all adults in the US should be eligible to receive a vaccine if they want it.

Ben Jeffery:

Now, optimism on this of course assumes a willingness by the population to take up that availability of a vaccine. But nonetheless, the pickup in inflation expectations that was not accompanied by a similar surge in real yields, has to be encouraging for the FOMC, especially ahead of Wednesday's meeting.

Ian Lyngen:

And as Powell has routinely said, "As goes the pandemic, so goes the recovery". I think that this will be an important inflection point for the combination of monetary policy, as well as the performance of risk assets with an improving outlook. One of my core concerns is that the \$1.9 trillion stimulus package is going to put upside risk on growth during the first quarter of the year, bringing forward consumption.

We're also going to see that combined with a renewed push to reopen, and re-engage the frontline service sector workers. My primary concern is that this is all occurring in a very condensed timeline. And what we risk is finding ourselves in the middle of the summer with everything reopened and most people vaccinated and still lacking that huge push in consumption that seems to be underlying market participants expectations

Ben Jeffery:

What's the root of that concern? Why are you thinking this surge and consumption may not ultimately come to fruition?

Ian Lyngen:

Well, it's twofold. First, I think we are seeing some of it play out right now. And by concentrating it in the first quarter, we risk losing momentum as the year plays out. That's one aspect of it. The other is, I'm skeptical that the uptake of the vaccine will correspond with its availability, thereby making the path back to some version of normality much longer than the market seems to be expecting. Keep in mind that alongside that May 1st date, the administration is also anticipating that by the 4th of July, things should be generally back to normal. Seems a little ambitious from my perspective.

Ben Jeffery:

And in terms of price action in the Treasury market, I would argue this fits pretty well with the typical seasonal patterns that we've seen in ten year yields. The optimism brought into the new year that typically defines the first quarter has played out to a great extent. Arguably in 2021, there's another leg of that trade that will play out on the back of the latest fiscal deal. But as summer begins and starts to play out, the rationalization of some of that exuberance could very well weigh on longer dated yields. This keeps with the average moves we've seen over the past 10-years or so when yields tend to reach their lowest point during any given calendar year, right around the end of August and early September period.

Ian Lyngen:

This also highlights one of the key debates in the Treasury market at the moment. And that is whether or not we're in the midst of a repricing that's akin to a step function. Where we sell off, consolidate for a period. Sell off another 15, 20 basis points, consolidate for a period. All with a longer term objective of getting rates back to normal. Let's call it solidly above 2%. Or if 10-year yields are simply in the process of defining the upper bound of the range and those seasonal factors combined with optimism running up against the headwinds of the realities of reopening the real economy will ultimately lead us back to an environment where 10-year yields are trending between 1 and 1.50, rather than trending between 1.75 and 2.25.

Ben Jeffery:

There's also the aspect of policy normalization expectations to consider around this reopening optimism. We've seen some of the more aggressive normalization expectations walk back a bit, at least as exemplified by the price action in the belly of the curve. But going into Wednesday's meeting where we do receive an updated SEP, it's going to be especially interesting to see how the 2022 and 2023 dots have evolved following the improvement in the outlook that we've seen since the last SEP, which was in December of 2020.

Ben Jeffery:

In those forecasts, we saw just five dots off the zero bound by the end of 2023. And I don't think it's unreasonable to expect that a few more committee members may be contemplating rates off zero by that point. To be fair, that's still over two years away. But it will be something to keep an eye on in addition to the formal statement of course.

Ian Lyngen:

Let us not forget that we also see the retail sales report for the month of February. This will be an important gauge of consumption if for no other reason than we're coming off of a very strong January number. And that January number has contributed to pretty impressive Q1 real GDP forecast. So as we look at the current consensus, expectations are for a modest three tenths of a percent decline in retail sales. But I'd characterize that as stabilization more than anything else. The real surprise would be if we had another five plus percent month, or we saw a give back comparable to the upside that was experienced in January. And recall that that January figure was largely assumed to be a function of the upside in stimulus. So even a disappointing February number will be easy for the Fed at least to dismiss given the fact that stimulus checks are going to be rolled out relatively quickly over the course of the next two weeks.

Ben Jeffery:

And alongside these more macro considerations, we have received a fair number of questions about the latest CFTC data and what was a move back to a fairly substantial short base in the ten-year sector last week. Assuming the short base persists, what this means going forward for yields is that it will likely serve as a limiting factor to any meaningful sell-off either to, or through 1.75. And that's simply going to be a function of short covering punctuating a journey toward higher yields that will make each subsequent lag of a bearish repricing incrementally more difficult.

Ben Jeffery:

Additionally, in historical context, the scale of the short base we're currently seeing is hardly noteworthy versus the extremes that we saw in 2018, 2019, and even the early part of 2020. So to me, it's more emblematic of some positional swings around the volatility we've seen over the past several weeks, rather than a true meaningful sentiment shift on the part of the market.

Ian Lyngen:

So a shift in sentiment, like the shift in seasons that's about to occur.

Ben Jeffery:

It has felt like people have spring fever this week.

Ian Lyngen:

Well, let's hope that's the only reason for the fever.

Ian Lyngen:

In the week ahead, the primary policy event will be the FOMC meeting on Wednesday and Powell's press conference that follows. Expectations are for no change in the composition or the pace of QE. No rate changes, although there had been some chatter about shifting the very front end rates in a fine

tuning effort to keep effective Fed funds in the range. We expect that given that a lot of that pressure has alleviated over the last couple of weeks, that we will see any such decision delayed until the second quarter. There is supply of note. We do have a \$24 billion 20-year auction on Tuesday, as well as a 10-year TIPS reopening of \$13 billion on Thursday.

Ian Lyngen:

From a data perspective, it's really just retail sales from February, which are expected to be effectively flat. Also, keep an eye on the weekly jobless claims data that continue to improve as vaccination optimism increases, and re-openings have replaced restrictions as the spring nears. As has been the case throughout most of late February and early March, we actually expect that the more interesting story will come in the form of the price action itself. To a large extent throughout the pandemic, the Treasury market has simply responded to other financial markets, whether it was risk assets, movements in monetary policy or the dollar. The Treasury market to a large extent had been in a reactionary mode.

Ian Lyngen:

2021 marks a definitive break from this dynamic. And we're seeing the progress higher in US rates really taking over as a macro theme. Now we expect that the bearishness will have some durability. That 1.75 level on 10-year yields looks pretty attractive at this stage. However, a lot of that assumes that the domestic equity market can remain at relatively lofty levels despite higher rates. Recall that 1.43 to 1.97 define the trading range between August 2019 and December 2019 long before the pandemic was really on the market's radar.

Ian Lyngen:

More importantly, that was an environment characterized by much higher monetary policy rates, by a much lower unemployment rate and higher labor market participation rate. In fact, in that period, we saw the unemployment rate dip as low as 3.5%. All with the backdrop of continued gains in equities, not dissimilar from where we are at this stage. The big difference was we didn't have the upside from stimulus nor the headwind from the pandemic. So even with accelerating inflation expectations, we struggled to see the 10-year yield sustainably breaking that range, which would bring a two handle for tens into play.

Ian Lyngen:

Instead, we're operating under the assumption that a lot of the bond bearish news has been brought forward. This has been reinforced by the most recent \$1.9 trillion bailout deal from Washington, as well as optimism that the journey out of the pandemic might be quicker than the market was anticipating at the end of 2020. 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 we ready to roll the clocks forward one hour at 2:00 AM on Sunday, we scoff at those who dismiss time travel as science fiction. Where did we put that flux capacitor?

Ian Lyngen:

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