New Year, New Problems - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 102, New Year, New Problems, 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 January 11th. And with only a few new year's resolutions still in place, we find our leisure time filled with riding a bike that goes nowhere, taking a jog that goes nowhere, climbing stairs that go nowhere, and rowing a boat that goes nowhere. We're at least grateful that the pandemic has left us nowhere to go.

Audio:

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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 first week of January has certainly shaped up to be an interesting one in the treasury market, if nothing else. We saw the breach of 1% 10 year rates for the first time in the pandemic. This is a level that we've been focused on for some time, and so we take solace in the fact that it broke. The question now quickly becomes, how far can that move run? Our first objective was an opening gap at 111 to 114. Beyond that, the next level that really matters is 125. And then there's an isolated yield peak at 127 in 10 year space.

Ian Lyngen:

The bearish momentum that is currently in the market has room to extend, although stochastics are somewhat oversold in tens, less so in the thirties. This really sets up an important litmus test given everything that has occurred over the course of this first week of 2021. The delayed blue sweep combined with the inflationary implications from the potential for more fiscal stimulus has created what one might characterize as the perfect bearish storm.

Ian Lyngen:

In the event that the market makes it through next week's CPI print and we haven't repriced to a sustainably higher rate plateau, it wouldn't be surprising to then subsequently see a round of consolidation. And as a result, simply redefining the upper bound of the prevailing trading range rather than recasting the overall trend or direction in the market. This has been our base case scenario for the first quarter, i.e., pushing the upper bound a bit higher, but still retaining the back and forth lack of a clear directional trend.

Ian Lyngen:

We ultimately do see tens ending 2021 at our higher rate plateau, but that won't be without periods of flight to quality that bring 10 year yields back below 1%. The economic data in the week just passed had very little net impact, most notably the disappointing nonfarm payrolls print, which was the first negative read since the big drop in April of 2020.

Ian Lyngen:

It also follows in this context that the curve re-steepened with fives, thirties reaching multi-year steeps, 10 year break evens pushed beyond 210 basis points, which is very consistent with the market pressing the one big trade of 2021, which is the reflationary cheapening of the longer end of the treasury market. We'll be the first to admit that this is a relatively crowded trade. We can see it in the CFTC data that has both the ultra long bond contract, as well as the classic bond contract demonstrating significant short positions.

Ian Lyngen:

Interestingly, TY is effectively flat, which would lend to the interpretation that the price action in the 10 year sector is comparatively clean. By that I mean that there's simply no headwind from profit taking or short covering as we push toward a higher rate plateau.

Ben Jeffery:

Well, Ian, happy new year.

Ian Lyngen:

Is happy really the right word? It was a pretty interesting start to the year, at least from a trading perspective and everything that's going on in the macrosphere. One thing that we did see that was certainly notable was the breach of 1% in 10 year yields. It was a long time coming, but we finally did see tens reach as high as 1.1% before what appears to be a potential round of consolidation got underway.

Ben Jeffery:

And the willingness of investors to push the sell-off well beyond that 1% line in the sand, even ahead of the jobless figures, was indicative of one of this week's primary themes and what will be one of this year's primary themes. This week's being the runoff elections in Georgia and the "delayed blue sweep" that now ostensibly increases the odds of another fiscal package once the process of turnover in Washington is complete.

Ben Jeffery:

And from a longer-term perspective, the underlying optimism that the economy continues to make its way through the pandemic, vaccines are still being administered, and inflation expectations linked to this optimism continue to rise. In addition to that 1% level and nominal 10 year yields, it's also worth discussing the rally in 10 year break evens, which reached as high as 211 basis points.

Ian Lyngen:

Another interesting question that this week gave rise to was will fiscal stimulus, A, occur, and B, become a more permanent go-to tool for Washington? Well, historically, there certainly is a track record for the government returning money to the population, assuming that the delayed blue sweep ultimately yields in another direct payment. We will have seen effectively three back-to-back checks cut for the majority of the labor market.

Ian Lyngen:

This brings up the question of just how permanent of a tool this might be for lawmakers and if we should expect that to be a go-to response if and when the economy falters again.

Ben Jeffery:

And the economy faltering again is certainly topical after the December nonfarm payroll is released. The economy lost 140,000 jobs to conclude last year. And while, sure, the prior two months revisions offset that to a great degree, nonetheless, the setback in the labor market recovery is going to call into question how sustainable continued hiring will be as long as COVID case counts continue to pick up, while vaccines are still being administered, and expectations on the timeline of herd immunity are refined.

Ian Lyngen:

One of my biggest takeaways from the nonfarm payrolls report was not so much the disappointing headline figures, but rather the treasury markets almost complete indifference to the number itself. Heading into the release, yields were effectively unchanged on the day. Once the numbers hit, there was a very muted response. We drifted somewhat higher in yields, but we're talking about one or two basis points as a range.

Ian Lyngen:

So the interpretation is that what we are seeing is a market far more interested in the prospects for additional fiscal stimulus and far more focused on the path of the pandemic than the admittedly dated economic data. Within the release, it still warrants acknowledging the fact that we did see an increase in average hourly earnings of 8/10 of a percent month over month. Now, that far outpaces the expectations for a 2/10 of a percent monthly gain in December.

Ian Lyngen:

But a lot of that is going to be simply a function of the composition of those who remained in the job market. Nonetheless, a year over year average hourly earnings print of up 5.1% is certainly encouraging to anyone who might have been fearing disinflationary pressures.

Ben Jeffery:

And relating to disinflationary pressures and that move and break evens we were talking about earlier, outside of rates specifically, the latest rally in the energy complex also implies a degree of upside and economic activity going forward. We've seen the front month WTI contract make it above $50 a barrel for the first time since the pandemic began. And while maybe not the primary driver of the pickup in inflation expectations we've seen to begin the year, it has contributed somewhat to the upward pressure on break evens and thus nominal yields.

Ben Jeffery:

Now, it wasn't that long ago that sustained deflation was a real risk as economic activity came to effectively a complete halt in March and April of last year, which is when we saw oil move negative. Yes, that was really a function of the point in the calendar and ultimately needing to take delivery of some of these futures contracts, but still the strength we've seen in demand for energy is indicative of some aspirations that economic activity is beginning to ramp up.

Ian Lyngen:

I think that's a key point, Ben. We had a lot of bearish influences in the market, commodity prices being one of them, the inflationary implications from additional fiscal stimulus, the continued run up in risk assets. All of this really created the perfect bearish storm for treasuries. And still we were not able to get a wholesale repricing that brought 10 year yields back to let's call it 125 or beyond. In fact, at 110 to 111, we start to push up against that technical opening gap at 111 to 114.

Ian Lyngen:

More importantly, the window for a more significant repricing is closing very quickly in the treasury market. If we look at stochastics and momentum, we can see that the market is flirting with being oversold as we move into a week that contains the 10 and 30 year auctions, as well as the CPI data for the month of December.

Ben Jeffery:

And the timing of the 10 year auction on Tuesday and the 30 year auction on Wednesday really aligns well with the momentum landscape that you touched on. Yes, we've seen an impressive sell-off to begin the year, but the fact that that wholesale repricing that you mentioned, Ian, has not come to fruition, reinforces the notion that there is demand for treasuries at these yield levels. Add to that the liquidity points offered by the treasury department via the auctions.

Ben Jeffery:

And for a very short-term tactical trade, buying any further back up toward that 114 level that we've highlighted in 10 year yields may ultimately prove prudent. If for no other reason than there's a real risk. We see a modest bullish retracement or an extended period of consolidation over the next week or so to work off some of these over done conditions, if nothing else.

Ian Lyngen:

It will be interesting to see how the data itself plays out in the week ahead, particularly CPI and core CPI. We've been referencing some of the key pandemic related drivers of inflation, new and used auto prices, as well as shelter costs. And those appear to have run their course via the November series. It will be informative to see whether or not they have taken a leg lower in December, given everything that has gone on via additional lockdowns, et cetera.

Ian Lyngen:

We're less convinced it's the actual realized inflation data that is going to drive the re-steepening and the push higher and break evens, however, or at least justify the push higher and break evens that we have already seen. We're still early enough in the recovery that investors don't expect any durable upward pressure on prices to be maintainable, although we will quickly move toward the period where the base effects become especially relevant in March and April.

Ian Lyngen:

All of this conspires to keep upward pressure on inflation expectations even if on Wednesday we don't see confirmation of that via the real data. For context, as it stands, the consensus for core CPI in December is an increase of just 1/10th of a percent month over month. That represents a slowing from November where the print was 0.2%.

Ben Jeffery:

And this is all occurring with the backdrop of a Fed that remains committed to continue providing as much monetary accommodation as possible. We heard from several Fed speakers this week, in addition to the minutes release, which revealed less urgency on the prospects for a WAM extension of QE than many were anticipating. Going into the December FOMC meeting, it really seemed like a 50-50 chance on if the committee would ultimately deliver.

Ben Jeffery:

But the discussion in the minutes showed that most members were comfortable with the composition of the bond buying as it stands. There were a few that were open to either extending the maturities of the buying or increasing them in outright scale. This may have contributed a bit to the steepening we've seen over the past week, but the potential for this policy to be implemented further down the road will continue to be something to consider in framing expectations for how far along end yields will ultimately be able to rise.

Ian Lyngen:

We also heard from Bostic at the beginning of the week talking about potentially reducing the size of QE by the end of 2021. Now that might be relatively consensus, but it still reduced some of the underlying bullish pressure further out the curve. The net takeaway being that while the prospects for a WAM extension still persist, especially if the economic data under performs as the year gets underway, the Fed is at least beginning to lay the groundwork for a taper at one point.

Ben Jeffery:

What about this week specifically? Not just in rates, but equities as well? We've seen the S&P 500 reach all-time highs again and 10 year yields move to within striking distance of that support level, which is an opening gap between 111 and 114. Is fading the first week of 2021's moves prudent yet, or is there still more room for the price action to extend?

Ian Lyngen:

I do think that this move in and of itself will ultimately be a good buying opportunity for treasuries. Less clear that it will be a selling opportunity for equities, however. In the event that we can push 10 year yields beyond 115 with a shot at 125 in the first quarter, I suspect that by this summer, investors will ultimately look back at those levels and consider them a gift.

Ben Jeffery:

So what you're saying is no such thing as a bad bond. Just a bad price?

Ian Lyngen:

How are your Sears bonds looking now, Ben?

Ben Jeffery:

Still too soon.

Ian Lyngen:

In the week ahead, the treasury market will benefit from a few key fundamental inputs, most notably being the CPI series on Wednesday. Core CPI looking for a 1/10th of a percent increase. This will represent a slowing from the recent pace. However, the year over year level is expected to remain at 1.6%. Given the relevance of inflation to the story of 2021, we expect a fair amount of emphasis will be put on the release. There's also the 10 and 30 year auctions on Tuesday and Wednesday respectively. Tens will be 38 billion and thirties will be 24 billion.

Ian Lyngen:

A pre-auction concession cheapening in the market that contributes further to the re-steepening narrative appears to be the path of least resistance. We're unwilling to fade the move just yet, although we will add the caveat that what's occurring at the moment is either, A, a wholesale repricing, or B, simply extending the upper bound of the range. All else being equal, we'll err on the side of assuming that we're simply expanding the upper bound of the range, which is a process that will run its course during the next week.

Ian Lyngen:

We also have the December retail sales print on Friday. Expectations are currently for a modest decline of 1/10th of a percent. Given the increase in lockdowns during the fourth quarter, as well as the implications for service sector employment and subsequently consumption, it goes without saying that the spending data on Friday will remain a relevant touchstone as we continue to balance the economic headwinds resulting from the pandemic against the optimism associated with the potential for even more on the fiscal side.

Ian Lyngen:

While the economic data will certainly contribute to the fundamental profile, the market has reached levels where it's the price action itself that will become the most defining. Looking at the fives, thirties curve in particular, 145 sticks out as a clear objective. The market has struggled to steep in beyond 140 on a sustainable basis. But in the event we can break through 145, this would represent a significant technical achievement, and one that would clear the way for a grind even steeper.

Ian Lyngen:

This does match well with the fundamentals of a Fed on hold for the foreseeable future. This implies that the front end of the curve, particularly twos and threes, are going to retain an even tighter range than they have previously. Further out when looking at the five-year sector, there is a bit more variability for rates. And with five years pushing up against 50 basis points, this should serve at least as an incremental headwind for the steepening trend that we expect to continue to characterize 2021.

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. And given all that has occurred since the holidays, we're comfortable rebranding this as the 13th month of 2020. No need to taint 2021.

Ian Lyngen:

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