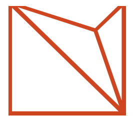

RUBRICS

Rates vs Risk Assets - A Renewed Tug of War

Fixed Income Macro View

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Macro Backdrop – Federal Reserve

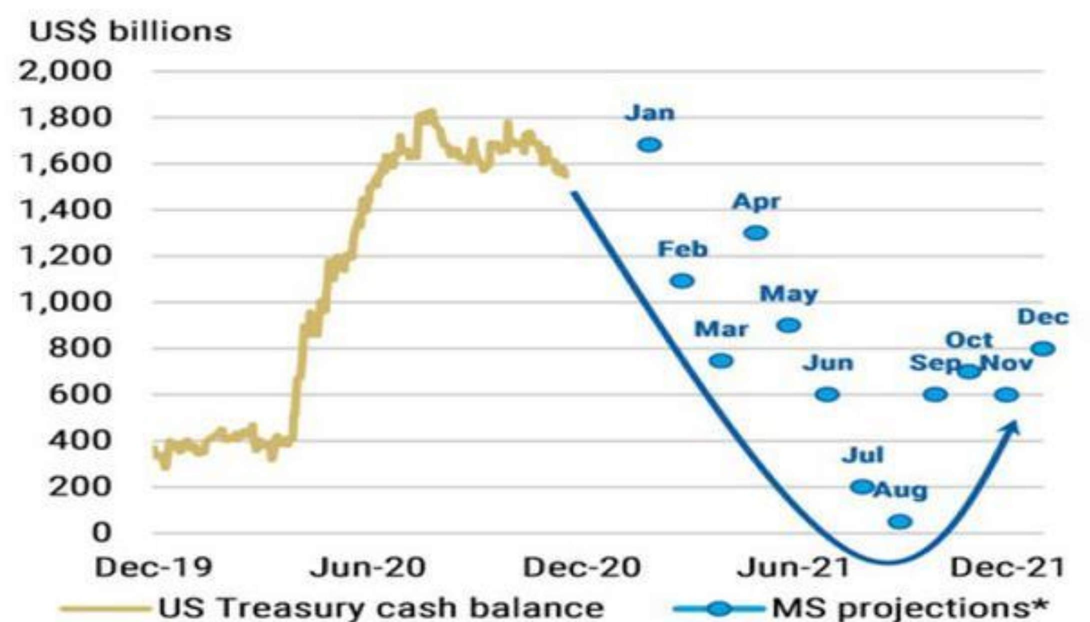
"I think we are actually at a point of encouraging risk-taking, and that should give us pause. Investors really do understand now that we will be there to prevent serious losses. It is not that it is easy for them to make money but that they have every incentive to take more risk, and they are doing so" - Jerome Powell, FOMC Meeting October 23-24 2012[1]

The above statement is striking insofar as it is almost completely at odds with the more recent proclamations from the now Fed Chair. His latest assertion that the relationship between interest rates and asset prices 'may not be as strong as we might think' certainly strikes a chord. A remarkable statement given the Fed have essentially relied on asset price rises to support aggregate demand in the economy. ***Furthermore, and despite growing concerns over financial stability from within the Fed[2], a clear signal that they will not be intervening to burst market bubbles anytime soon.*** Not until the economy overheats at any rate. With fiscal policy now playing a more prominent role than ever, the MMT movement continues to throw timber on the fire. Notwithstanding the warnings from the likes of Larry Summers[3] over the potentially dangerous inflationary impacts of the Biden plan, the message from the top is loud and clear. Economy first, financial stability second. This 'go big or go home' approach to policy making is not a solid foundation for sustainable productivity-led growth. Whatever short term gains may accrue can quickly be undermined by another financial crisis.

Macro Backdrop - US Treasury Liquidity

The market appears to be facing yet another avalanche of liquidity - this time from the US Treasury. The Treasury General Account balance at the Federal Reserve currently stands at $1.6tn. This account is where the Treasury holds money it has raised from bill or bond sales but has not yet spent. The balance was built up in 2020 as the Treasury pre-funded pandemic stimulus spending and Federal Reserve lending programs. This balance is predicted to decline significantly in 2021, as seen in the below projection from Morgan Stanley.

US Treasury General Account Balance and Morgan Stanley projection for 2021



Source Morgan Stanley 30/11/20

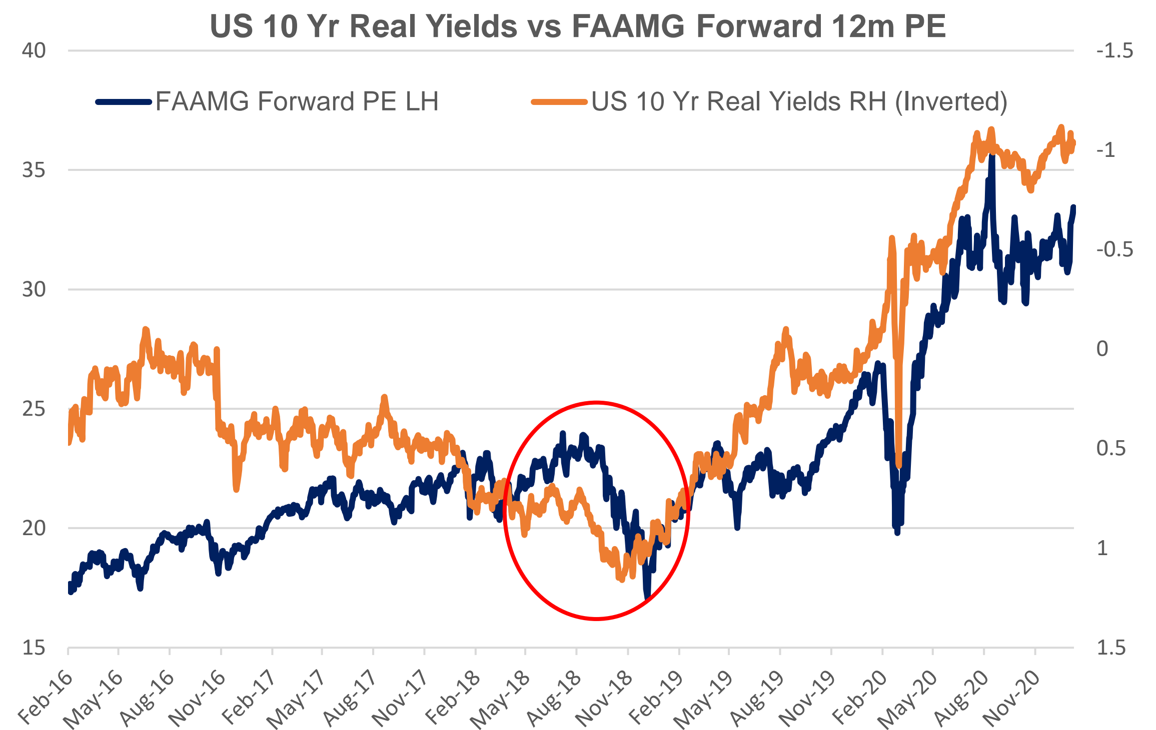
As Biden's administration looks to pass its $1.9tn stimulus package, the market is speculating that the Treasury General Account balance can be used to fund this spending, or some combination of the balance plus bill or bond sales. As the Treasury General Account balance falls, in order to keep the Federal Reserve balance sheet size from falling, the Fed effectively swaps the TGA balance for bank reserves held at the Federal Reserve. This would see a significant rise in Bank Reserves, historically highly correlated with a move lower in USD.

1: https://www.federalreserve.gov/monetarypolicy/files/fomc20121024meeting.pd
2. https://www.bloomberg.com/news/articles/2021-02-18/fed-staff-suggest-more-worry-over-financial-risk-than-powell
3. https://www.ft.com/content/2ed793d2-fb65-4ec7-9b4c-5851b2c780f3

Market Outlook

Given the considerable support underwriting the capital markets the near term outlook for asset prices is positive – irrespective of valuations. In addition to the Fed and Treasury liquidity already discussed, newly minted households with their $1400 cheques will also add impetus to the economic re-opening. Given this backdrop, we discuss our outlook for some of the key areas affecting both fixed income and wider risk assets:

Facebook, Apple, Amazon, Google (FAAMG) Forward PE vs US Real Yields



Source Bloomberg as at 31/01/21

Government Bond Yields

Inflation expectations look set to continue their ascent which will likely put further upward pressure on bond yields. With commodity prices looking well supported for the next few months at least, markets will continue to be nervous about the prospect of higher yields. ***The question of how high yields can go before they become a problem for risk assets is starting to rear its head once again.*** On this point, the relationship between real yields and equities can be instructive given their historically negative correlation. Casting our minds back to 2018, the Fed acted too aggressively and caused a tightening in financial conditions. In this instance it took a ~40bp increase in real yields to threaten a collapse of risk assets. Given the increased leverage in the system its hard not to believe a move of similar magnitude would present even greater challenges. However such is the volume of liquidity in the system, the bond market will likely overshoot before the crunch is realised. In addition, there is an underlying assumption that should yields rise too quickly, the Fed will step in with some form of yield curve control. While this certainly wouldn't be their first full 180 on policy, it remains to be seen at what point they would be willing to intervene or indeed under what circumstances,

US Dollar

A continuation of the declining dollar witnessed throughout much of 2020 has so far failed to materialise in 2021. This has been due largely to outperforming economic growth in the US. If this pattern remains, ***the challenge for risk assets will be a potentially improving dollar which can offset some of the otherwise loose financial conditions***. It will be become a straight fight between excess liquidly and economic performance. During the initial decline in 2020 the liquidity story won out for the most part. Looking ahead, the requirement for yield on all of the excess cash in the system might drive more positive performance in EM, although it may be a tight balancing act. We can expect some support for this via the Treasury liquidity infusion mentioned earlier.

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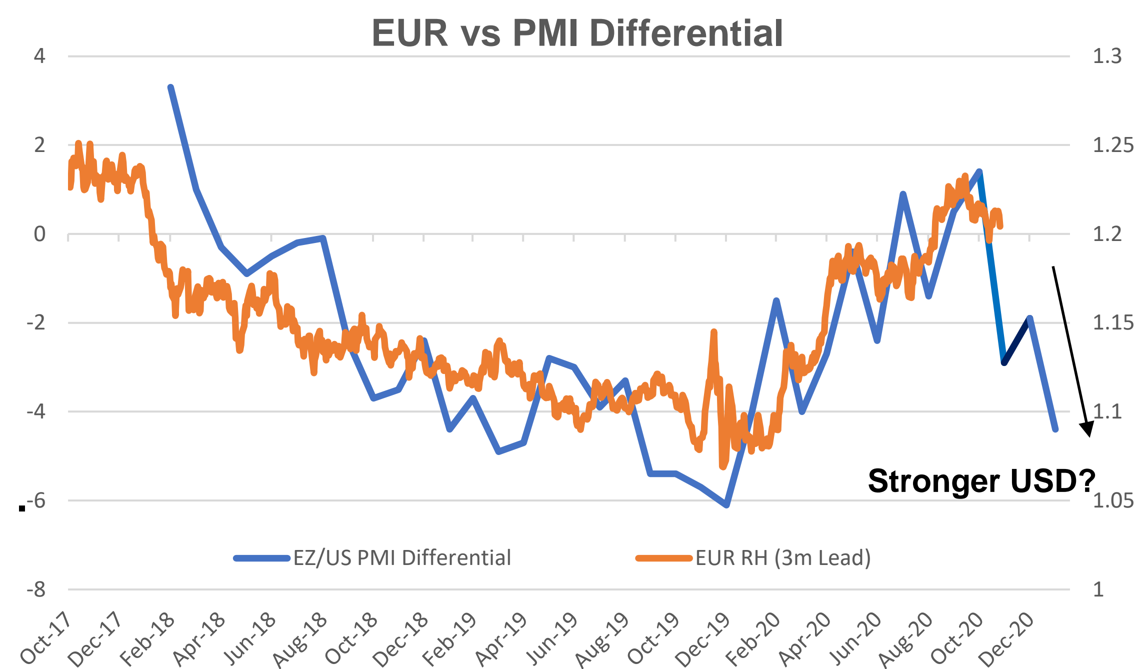
Longer term if the US reacts positively to massive stimulus (regardless of Covid SME scarring) then the dollar should hold firm, but if the stimulus fails to do its job than a weaker dollar might be expected.

EUR/USD vs US/EZ PMI Differential

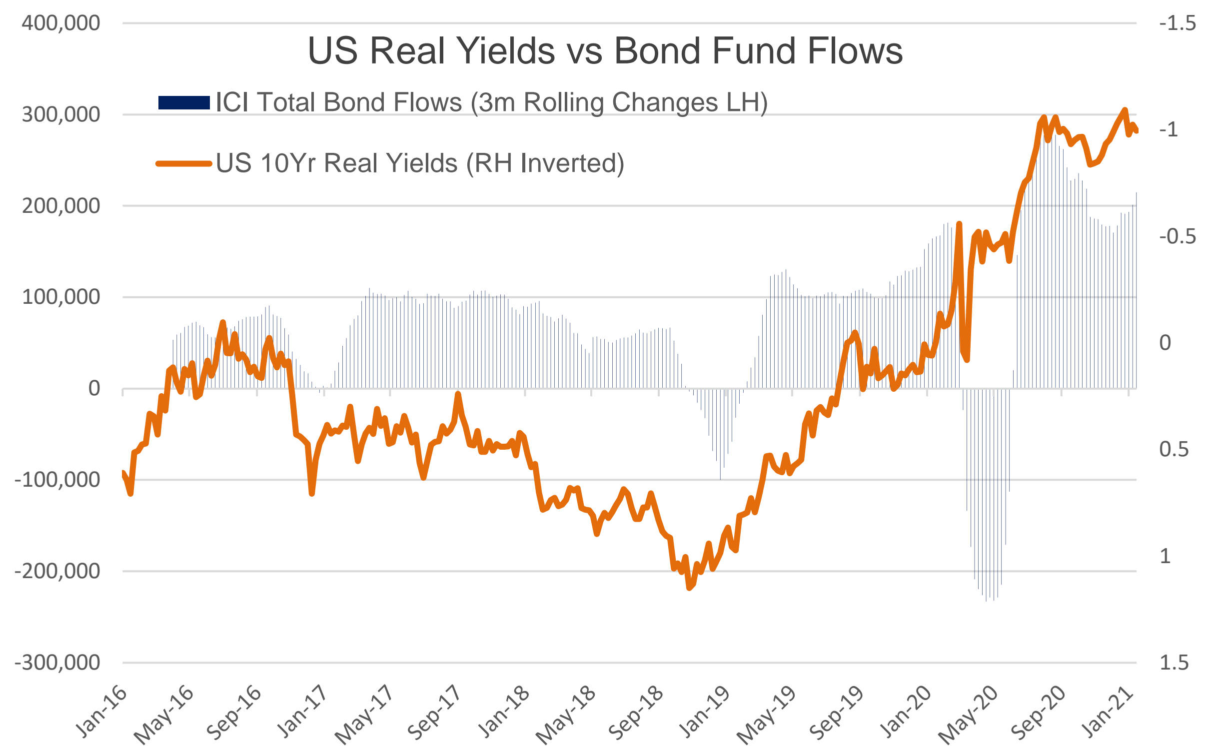


Source Bloomberg, Markit as at 31/01/21

Credit Spreads

With credit spreads moving sideways to marginally tighter since the end of December, there is currently little room for protection against raising government yields. As the hunt for yield continues unabated, investors are moving down the credit curve - dropping high yield for leverage loans or MBS for CMBS for example. ***Given the extended durations of many of the fixed income indices in the IG space as well as hard currency EM, the margin for error against rising yields is razor thin.*** It is not surprising that more and more investors are looking to local bond markets like China. As with broader risk assets, a sharp rise in real yields can also see a dislocation in credit through a tightening in financial conditions. So far in 2021, higher yields have seen longer duration strategies suffer – LQD (USD IG) and EMB (USD EM) ETFs are both down -3% ytd[1], with shorter duration strategies outperforming.

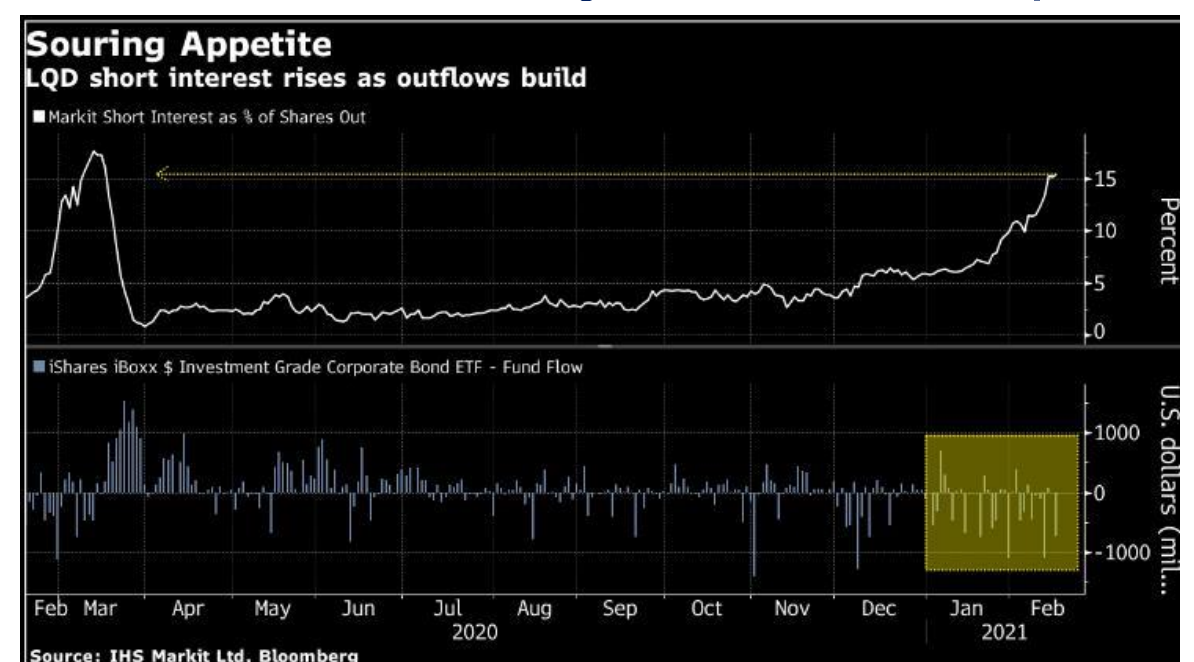
US Real Yields vs Bond Fund Flows



Source Bloomberg as at 31/01/21

The extent to which this can feed into outflows will be certainly worth keeping an eye on over the coming weeks and months. Perhaps the bigger question pertains to solvency, and whether non-performing loans and companies will be allowed to fail in 2021 or will the day of reckoning simply be postponed into 2022 and beyond.

Short Interest in LQD - Long Duration USD IG Corp ETF



Source Bloomberg as at 15/02/21

1. Source Bloomberg as at 16/02/2021

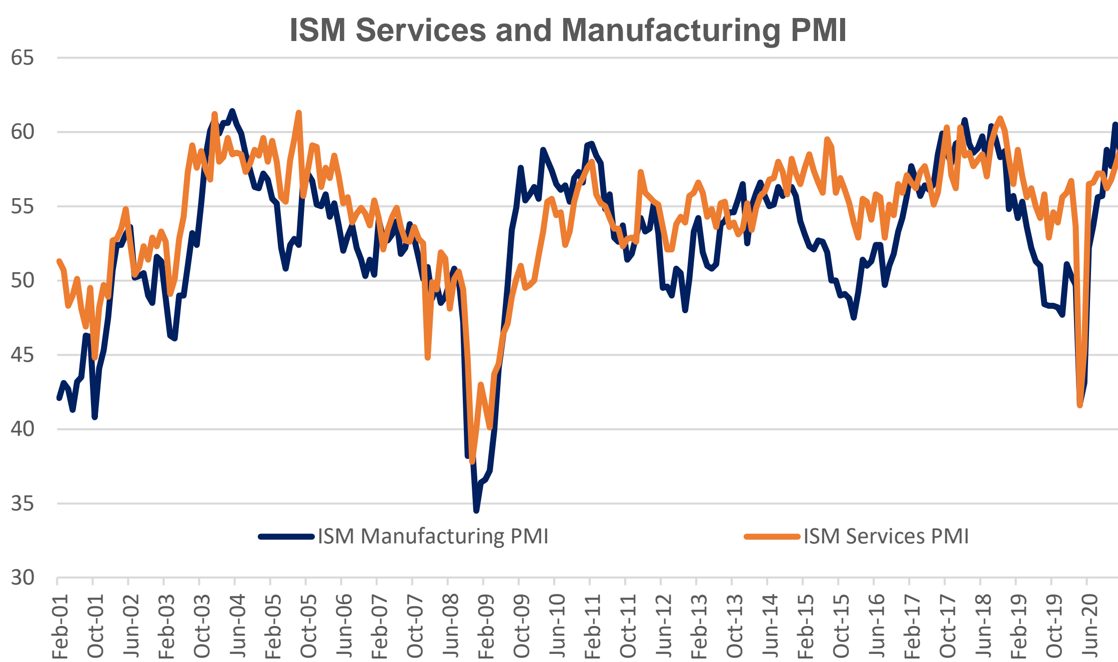
Rubrics Fixed Income Macro View

February 2021

Economic Data

Overall economic conditions appear to be far stronger throughout the latest Covid lock-downs than was evident in Q1/2 2020. Companies and individuals have learnt to go about their business with greater efficiency during these trying times. Recent ISM data indicates this strong underpinning to the economy.

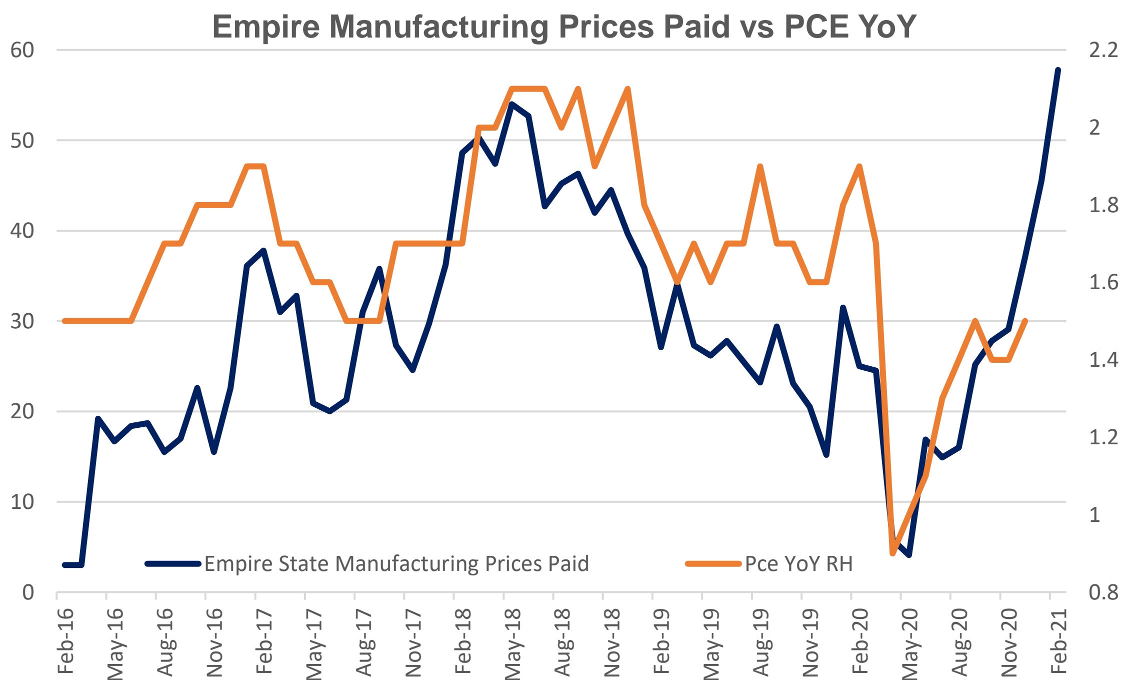
US ISM Manufacturing vs Services



Source Bloomberg as at 16/02/21

It is worth pointing out that some of the positivity in these numbers is related to supply side issues, which means upcoming hard data may underperform some of the soft survey data. Examples of this can be seen in issues around a lack of parts (microchips) within the auto industry. The Fed have been quick to give their two cents on this informing the market they will not be intervening in response to price pressures seen as transitory.

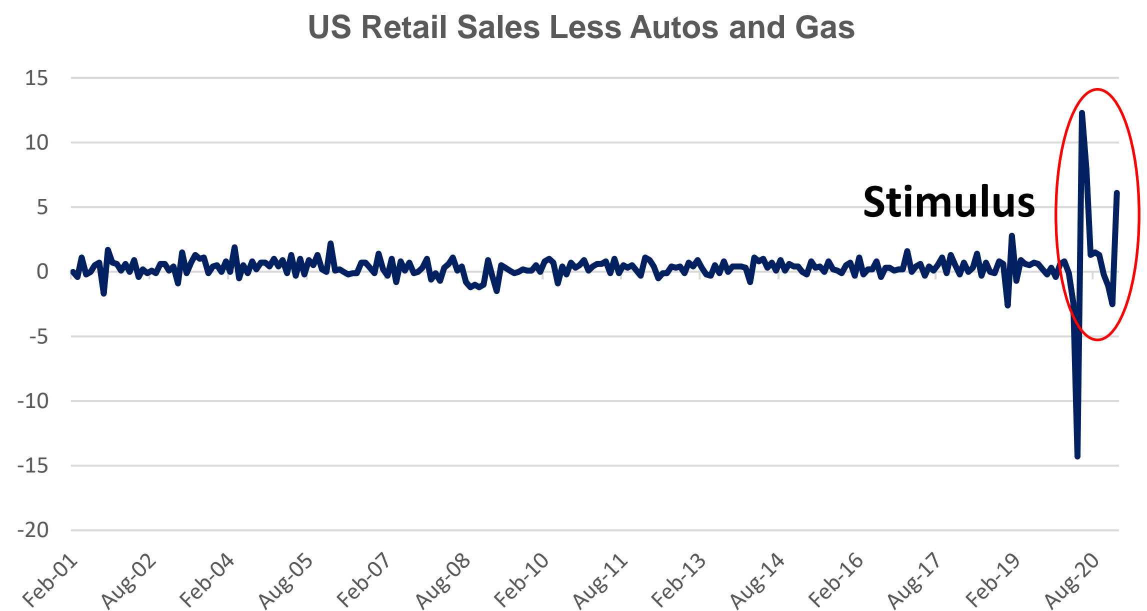
Prices Paid vs PCE



Source Bloomberg as at 16/02/21

The main boost from current data will likely come from services, who have been most heavily impacted by Covid, as economies open up cautiously. As the vaccines continue to be rolled out at pace in the US, it would be expected that stimulus plus pent up demand would support a strong data for the coming quarters. Inflation will be the data point to watch with regards to asset prices which have already priced in a strong rebound. On that front we will likely see a tug

US Retail Sales



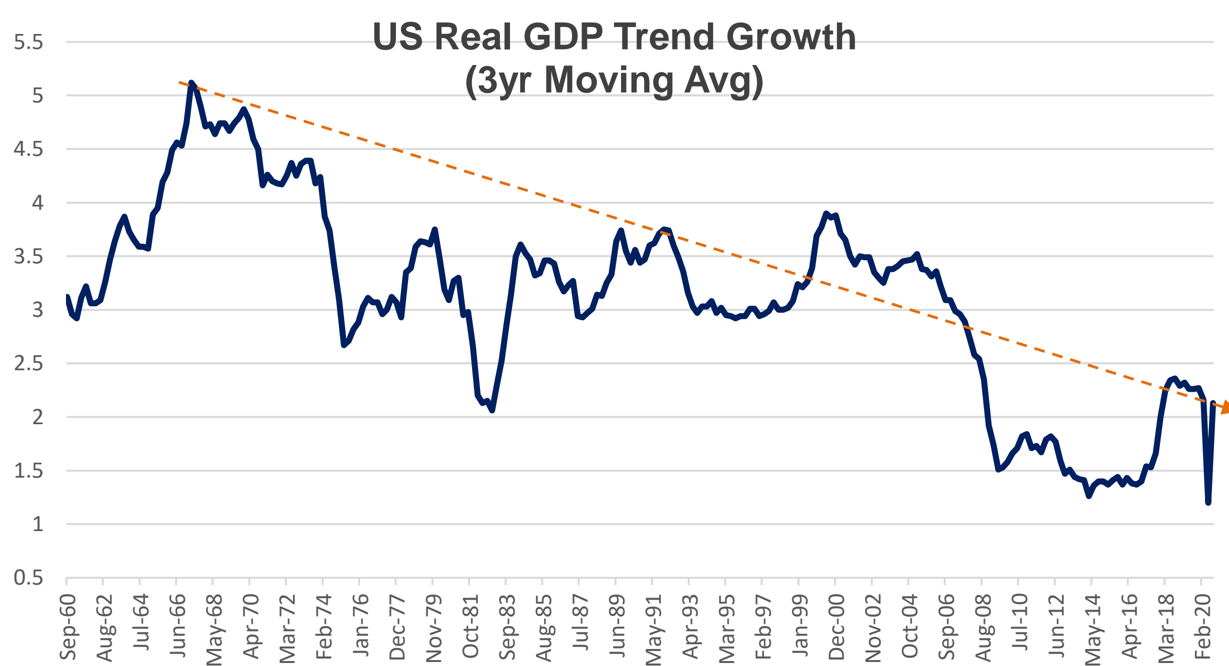
Source Bloomberg as at 17/02/21

of war between stimulus driven reflationary forces (e.g commodities) and continued supply side pressures on the one hand, and deflationary forces in the form of declining rents and persistent unemployment on the other. The fear/hope of central banks will be inflation expectations become more ingrained in the system which develops a potential shift in long term trends. A lofty ideal given the deflationary nature of the structural debt overhang. Inflation will only become a long term reality through the policy choices and structural changes we now make.

In Summary

Increasing productivity creates revenue growth and real wealth creation. Stimulus aimed at consumption creates additional debt which stifles investment, consumption and productivity. Economic history has been clear on this point. The income replacement and unemployment protection provided post March has been invaluable in keeping millions out of poverty. However we are now at the stage where the total COVID related stimulus is multiple times the size of the economic hit in the first place, with much of it poorly directed. In essence the K-shaped recovery. The winners and losers are the same ones we have seen emerging from previous crises. Given what we know of the set of policies set out by the Biden administration, to expect anything other than a euphoric blip in the long-term trend of falling growth levels would be extremely misguided.

US Trend GDP



Source: Bloomberg as at 08/02/21

Todays capital markets are reacting to massive amount of financial repression, driving real rates to once unimaginably low levels. Incessant money printing destabilised capital markets to the point where price discovery and the efficient allocation of capital has all but disappeared. Economists and politicians, hiding behind the recent history of low inflation and market 'stability', are living in a linear world where cause and effect are static. However, we live in a dynamic world where structural changes are continuing to stay one step ahead of policy makers who continue to fight the last war with the same tools.

Post the euphoria we will see a degree of consolidation as economic life returns to normal and pent up demand is unleashed. There will be inflation scares, some from base effects and others supply side driven (as discussed). Once the worst of Covid is behind us, it is likely that economic and market realities will start to realign somewhat. We will need to select inclusive pro-growth, pro-investment policies to build a more sustainable future with a shift towards investment, education and trade and away from S&P targets. That will include accepting that current asset bubbles will have to burst. Biden may be willing but will big business prevent congress from following through?

IMPORTANT INFORMATION

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