SPOTLIGHT

Normalisation of long-term yields – The next stage in the post-2008 transition

Financial markets appear to be in the midst of normalising US bond yields to levels consistent with rising US policy rates. We look for the 10-year US government bond yield to move towards 3.0-3.5% as bond markets more properly price the macro backdrop. But strong growth and earnings expansion mean the impact on equity markets should be muted once the bond market re-prices to this new range. Bond investors should continue to manage risk proactively, rotating away from conventional bonds in credit and embrace the de-correlating properties of non-directional strategies and Catastrophe bonds.

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UNION BANCAIRE PRIVÉE

Key points

- *The move to 2.8% on US 10-year Treasury yields is consistent with the normalisation process unfolding across the US yield curve.*
- *Further increases to 3-3.5% would still be consistent with a 100-150 bps real rate on 10-year Treasuries as seen during the 'Taper Tantrum' of 2013.*
- *The weak USD despite the rise in yields suggests the drag on the US economy will be more modest than seen in the post-Taper Tantrum period.*
- *Falling equity risk premia to date has offset much of the rising interest rate impact on broader equity prices until recently. Should yields stabilise near 3%, equities can rely on earnings growth as the primary total returns driver in 2018.*

Though rapid, the move from 2.4% on US 10-year Treasury yields at the start of 2018 to 2.8% in early-February is consistent with the 'normalisation' process that began in interest rate markets with the rate hiking cycle of the Federal Reserve in 2015.

Admittedly, we were surprised through much of 2017 that longer-term interest rates, like US 10-year Treasury yields had not responded similarly to the normalisation process begun at the short-end of the yield curve. However, it now appears that this process is well underway and investors should expect yields to move towards the 100-150 bps above core inflation that characterised the peak of the 2013 'Taper Tantrum' period for an equivalent current nominal yield of 3-3.5%.

As the Federal Reserve began to normalise its monetary policy regime, first via the 'tapering' of its bond buying programme and then via its hikes in the Federal Funds rate, we pointed out that the normalisation process would seek to reverse the effects of quantitative easing and rate cuts in the aftermath of the Global Financial Crisis by moving real interest rates from deeply negative to, first closer to zero and then gradually back towards their positive, pre-2008 ranges.

In the context of the Federal Funds rate, the Fed has largely achieved the first objective of 'normalisation' by moving the rate from deeply negative territory to now close to zero, after adjusting for inflation. With our expectation of core inflation in the US rising to near the Fed target of 2% in 2018, the consensus among voting members of the FOMC of three rate hikes in the year ahead is consistent with a desire to keep real Fed Funds near zero.

Looking ahead to longer-term interest rates, it is worth remembering that quantitative easing by its third iteration in 2012 targeted purchases of longer-term maturities to drive down longer-term bond yields, providing stimulus to the broader economy. Indeed, following QE3, 10-year yields after inflation fell to well below 0%.

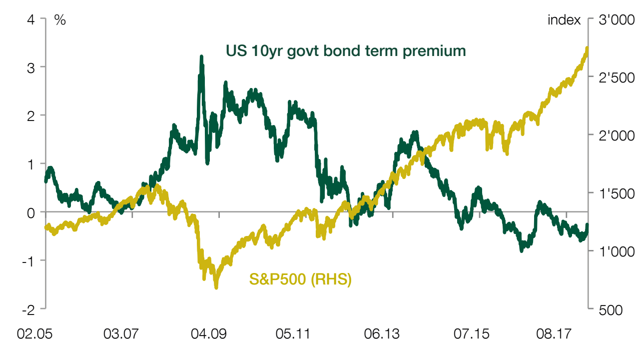
As the Fed began 'tapering' its purchases in 2013, real long-term interest rates rose rapidly to 1-1.5% after inflation. In retrospect, even the Fed now acknowledges that the pace of this move was too fast resulting in a strengthening of the US dollar and a sharp slowing in the US economy and a return to the 0% real interest rate area.

As the Fed's normalisation policy expanded to include selling bonds previously purchased, real yields have begun rising despite softness in inflation in 2017. Therefore the rise in nominal US 10-year yields from 2.1% in July, 2017 to 2.8% in early-February, 2018 appears to continue this normalisation process.

Interestingly, however, unlike in 2013, the US dollar is currently exceptionally weak perhaps offering a buffer for the broader US economy, not present during the 'Taper Tantrum' of 2013, which saw the US economy teeter on the edge of recession by 2015-16.

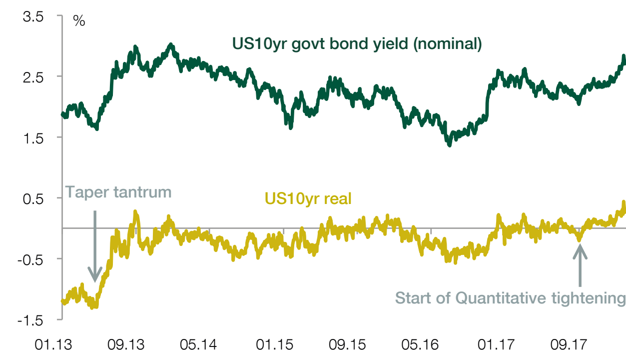
At 2.8%, US 10-year yields now sit near 100 bps above US core inflation, still towards the lower end of the 100-150 bps range seen in 2013. With the dollar remaining weak and with the benefits of fiscal stimulus, investors should not be surprised to see US yields move to the higher end of the range. As we expect the current 1.8% core inflation to accelerate to closer to 2.0% in the months ahead, this suggests that it would be reasonable to expect a move to as high as 3.0-3.5%.

S&P500 & US 10yr term premium



Source(s): Federal Reserve Bank of New York, Bloomberg Financial L.P.

US 10yr bond yields



Source(s): Bloomberg Finance L.P.

Implications for equity and bond markets

Though investors rightly worry about the implications of such a rise in yields for equity markets, corporates have prepared well for this day as most have extended maturities of debt on their balance sheets and moved to fixed rate issues to provide some protection against rising bond yields in the near term. With growth remaining strong, we do not expect the move in bond yields to have a significant effect on earnings for corporates.

What the sell-off in recent days does reflect is that markets are no longer offsetting the rise in long-term rates with declines in risk premia, a trend that has been in place for much of 2017. Rather, with risk premia having compressed meaningfully from their peaks during the Eurozone Sovereign Crisis, market action suggests that further risk premia contraction seems unlikely.

However, with little systemic stress within the global economy as seen in 2008-09 or during the heights of the eurozone crisis, neither do we believe that risk premia should move sustainably higher from current levels.

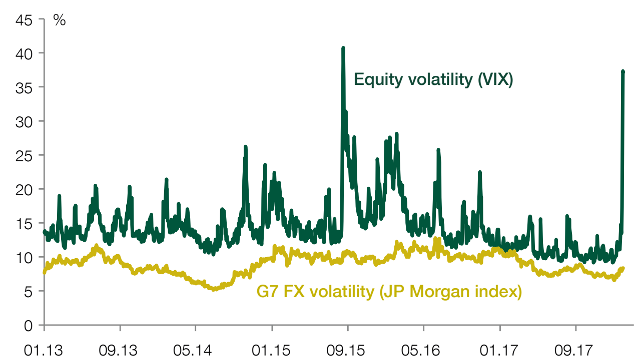
Instead, investors should expect markets to continue to digest the normalisation in bond yields towards the 3-3.5% range expected in the weeks ahead. As they do, we expect a renewed focus on earnings growth, which remains robust in the US, Japan and emerging markets continuing to suggest that attractive opportunities should present themselves in selected equity markets around the world.

As this takes place, we encourage investors to, once again revisit their tactical hedges in place in portfolios. The spike in volatility and sharp falls in markets have been cushioned by put-option protection within portfolios.

However, a stabilisation in volatility suggests that investors should rotate away from these protection strategies we had begun recommending in late-2017. Augmenting our put option protection within portfolios, we have opened a long Japanese yen exposure in portfolios, complementing existing positions in gold which have provided stability to otherwise volatile movements in equities and bonds.

For bond investors, the rapid moves in long-term interest rates in recent days highlight the ongoing asymmetric risks embedded in bond and credit markets around the world. As outlined earlier, we believe that we are in the midst of a long-cycle inflection in the interest rate cycle which will present headwinds for bond investors looking forward. With spreads near all-time lows, we continue to believe opportunities to diversify risk within the bond universe are warranted. Though short duration positions have served us well in the recent sell-off, similarly, positions in non-directional strategies as well as Catastrophe bonds have helped bond portfolios to weather the storm in recent days.

Volatility



Source(s): Bloomberg Finance L.P.

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