بنك أبوظبي التجاري ADCB ASSET MANAGEMENT LIMITED

Fixed Income Strategy- Reducing duration on US Treasuries

- **The Fed has been complacent with the recent rise in long-term US Treasury (USTs) yields, stating that they signify confidence in economic growth**
- **With no likely Fed intervention (as long as signs of tightening US financial conditions are absent), the long-term rates are likely to test key levels**
- **Despite the rising inflation expectations, we believe that uptick in inflation is likely to be temporary due to base-effects and signs of "cost-push" inflation trend**
- **However, market concerns on inflation are likely to flare up with actual inflation data appearing to be inflationary, despite Fed's assurances that the spike in inflation will be temporary**
- **The disconnect between markets and the Fed in relation to inflation pressures in 2021 could lead to more volatility in the long-end of the UST curve**
- **We recommend reducing our duration to intermediate (5yr) bonds, still maintaining our overweight stance on US Treasuries**

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Brace for interest rate volatility- Reducing duration

In our **Global Fixed Income Outlook 2021** published last month, we had outlined our view that the 10yr UST yields will not remain capped, after having risen by 50bp then. This view was mainly based on our expectation that the Federal Reserve will not only try to calm the markets on inflation concerns but would also be ready to step in if there is increased volatility in the long-term bond yields. Few developed market central banks like Reserve Bank of Australia and also the ECB were recently compelled to intervene in the bond market, in order to stem the rise in bond yields. However, Fed's commentary over the past month and the latest FOMC meeting has confirmed that the Fed seems comfortable with the rising bond yields and thus also comfortable with the steepening yield curve. In addition, the rise in UST yields has failed to attract demand from Japanese or European investors despite the UST yields looking attractive at current levels when hedged in their currencies. Market concern on rising inflation have not diminished, as evident from climb in inflation expectations, despite the Fed making assurances that it will overlook the (temporary) uptick in price pressures. This disparity between markets expectation of inflation and Fed's outlook has raised the interest rate volatility, with the markets pricing in aggressive rate hikes in 2023. Though we believe that the inflation risk premium is already priced in the long-term UST yields, markets doubt on Fed policy could continue to put pressure on long-term UST yields. ***As a result, we recommend reducing duration from our previous preference to medium-to long part of the curve to the belly (5yr) of the UST curve***. The intermediate bonds will still provide a good diversification against equities, if we do see any disappointment in economic data. Separately, medium term bonds will be less vulnerable to interest rate volatility compared to long-term bonds on a duration-risk adjusted basis.

Table 1 : Global fixed income asset allocation

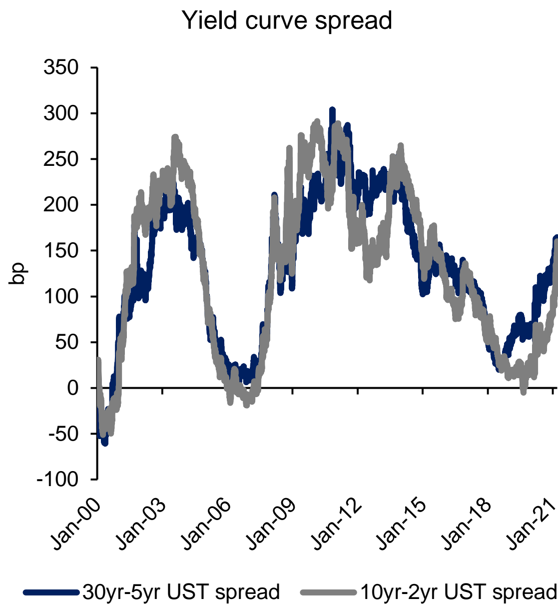
Fixed income	Underweight	Neutral	Overweight	Comments
Duration	■			Reduce duration to 5yr bonds
US Treasuries			■	Prefer US Treasuries as a hedge
US Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		Bottom-up approach is key: BBB sector attractive
- High Yield (off benchmark)	■			Bottom-up approach is key: BB sector attractive
European Bunds		■		Slow vaccine progress and Covid restrictions
European Credit				Weak growth concerns to remain
- Investment Grade		■		QE program in the form of CSPP to support
- High Yield (off benchmark)	■			Weak growth prospects to weigh
UK Gilts			■	Excessive pricing in of tightening cycle
EM USD Sovereign		■		Rising UST rates to weigh, selectivity is key
- Brazil			■	
- Russia			■	
- High quality GCC			■	
EM LC Sovereign		■		Tightening monetary policy cycles
EM Corporate	■			corporate leverage is concern, opportunities in Asia
- EM Asia			■	Preference for Asia IG

Source: ADCB Asset Management

Let the curve steep

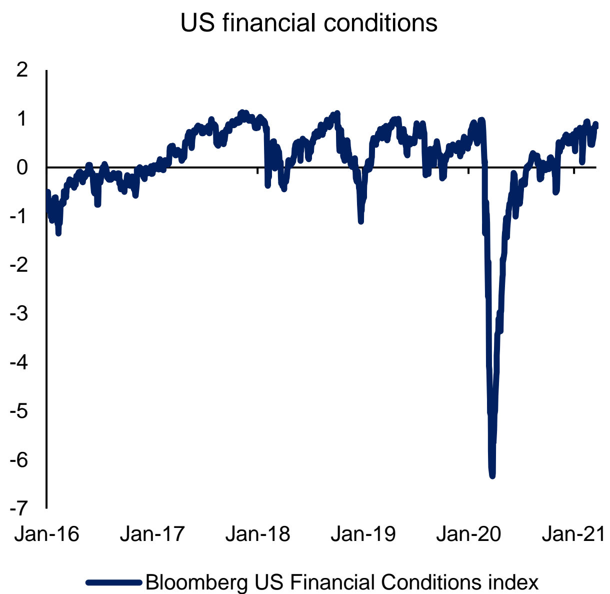
One way in which the Fed has surprised us (also the bond market) is the fact that the central bank remains comfortable with the rise in long-term bond yields. Over past month in several speeches and now finally at the FOMC meeting, the Fed has confirmed that the recent rise in bond yields is a sign of improving growth confidence in the economy. With its stance of no rate hikes until 2023 and being complacent with rising long-term UST yields, the Fed seems comfortable with the steepening UST yield curve. As a result, the cap that we expected the Fed could provide on long-term rates looks difficult to happen now, keeping the long-end rates susceptible to market volatility. The Fed could take action only when and if the US financial conditions start showing signs of tightening. At current levels of UST yields, US financial conditions remain loose (Chart 2). The first signs of any stress in US financial conditions will be evident through tightening of credit spreads. So far, corporate bond spreads have been relatively resilient to the sell-off in US Treasuries. It is difficult to determine at what levels of UST yields will start signaling tightness in US financial conditions and as a result, bond markets will continue to test that level. In addition, given the fast pace of recovery that we are likely to see this year (unlike previous business cycles), there is more scope for the UST yield curve to steepen (Chart 1). In previous business cycles, the 10-2yr UST curve has steepened by almost 200-300bp (from trough to peak). While the 10-2yr UST yield spread has risen close to the widest level seen in 2016, it has not widened to the same extent as typically seen during the previous recovery periods. As a result, **we recommend reducing duration to the belly (5yr) of the curve**. We also expect interest rate volatility to increase with continuing discord between the markets and the Fed when it comes to upcoming inflation risks and beginning of the tightening cycle.

Chart 1: Let the curve steep



Source: Bloomberg, ADCB Asset Management

Chart 2: as long as Financial conditions remain loose



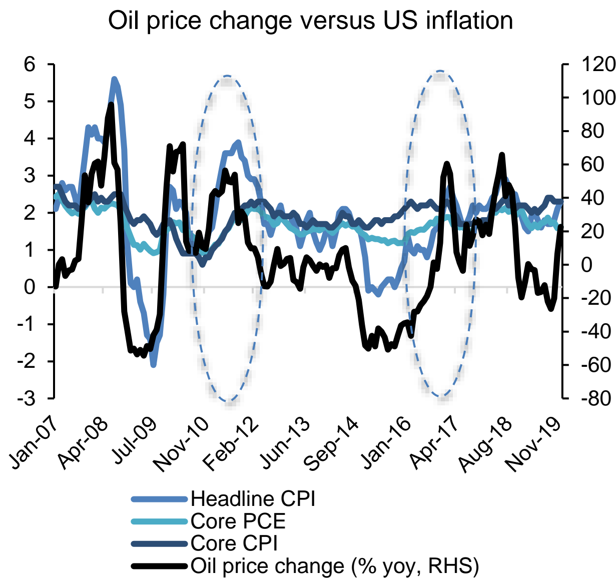
Source: Bloomberg and ADCB Asset Management

Market versus the Fed: Inflation risks

Since the beginning of the year, long-dated US Treasuries have come under selling pressure, pricing in better economic prospects and inflation concerns. Progress in vaccine distribution, decline in Covid-19 cases in the US and finally, the big bang Biden's stimulus USD1.9trn now being implemented has raised the prospects of faster and bigger than expected economic recovery in the US. Higher growth expectations have driven market expectation for inflation, also bringing forward concerns of an early than indicated exit from loose monetary policies. The Fed has affirmed the improving economic growth prospects in its latest FOMC meeting where the central bank upgraded its growth projection to 6.5% in 2021 from previous 4.2%. However, the Fed has been persistent that it will be overlooking the jump in inflation pressures as it expects an uptick in inflation to be temporary. But despite Fed's assurances, the market don't seem to believe the central bank as inflation expectations continue to grind higher.

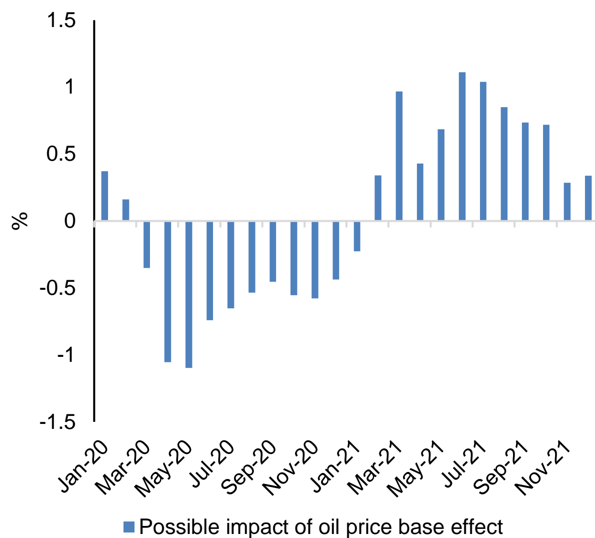
One thing that is certain when it comes to inflation is that inflation in the near –term will be higher, mainly on base effects. Oil prices have significantly recovered from their all-time lows of last year and this will put upward pressure on inflation (Chart 3). But the upward pressure will be visible mainly in headline inflation and not necessarily in core inflation which strips out the food and energy prices (Chart 4). The Fed's preferred gauge of inflation is also the core PCE. Overall, we are in Fed's camp and believe that rise in price pressure will be temporary in nature. Rise in commodity prices coupled with increase in input prices point to a "cost-push" inflation trend- which tends to be temporary in nature compared to demand driven inflation. In addition, a sustainable rise in inflation, even with a massive fiscal package, looks challenging given the degree of economic slack in the labor market. During the past, inflation failed to pick-up on a sustainable basis even during periods of low unemployment and higher wage gains. Some of the structural drivers including demographic, technological changes and subdued wage bargaining power-responsible for lack of pick-up in inflation are here to stay.

Chart 3: Oil prices have recovered from their lows



Source: Bloomberg, ADCB Asset Management

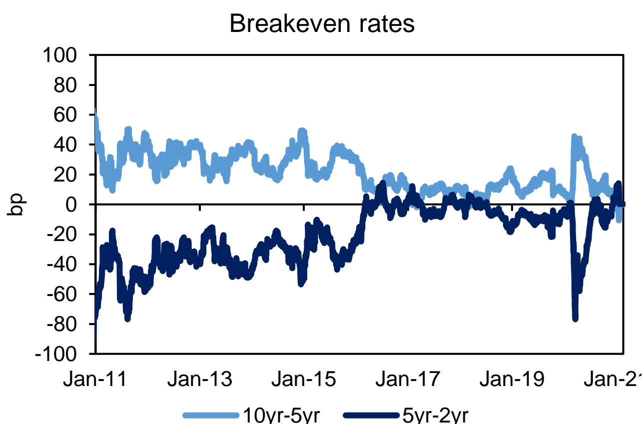
Chart 4: US Headline CPI to rise due to base effect



Source: Bloomberg and ADCB Asset Management

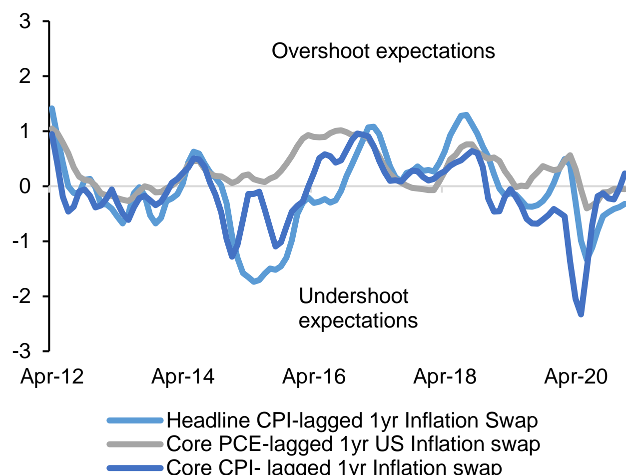
While upcoming inflation appears to be transient in nature, it is also important to acknowledge that the left-side tail risk of disinflationary pressures is slowly diminishing. At the same time, it remains crucial to track and analyze whether these temporary factors could potentially lead to medium term rise in price pressures. Rising inflation expectations is a key risk as they could feed into the real economy through business policy changes and workers asking for higher compensation. We fear that the upcoming data, which will appear "inflationary" to the markets could further lead to jump in inflation expectations. The recent trajectory of the US breakeven rate and the kink of the US breakeven curve signals that the markets are expecting inflation to pick-up on a medium term basis. The 5yr US breakeven rate is trading at a level higher than the 2yr breakeven and the 10yr breakeven (Chart 5). This differs from the Fed's expectation of future inflation. The recent economic projection released by the Fed point to inflation jumping by 2.2% in 2021 but later subside around 2% level in 2022-2023. Historical precedents indicate that the markets have not always been correct with the inflation outlook (Chart 6). In the past 20 years, the difference between actual inflation data and the 1yr inflation swap shows that actual inflation numbers have negatively surprised, undershooting the expectations.

Chart 5: 5yr breakeven rate higher than 10yr and 2yr counterpart



Source: Bloomberg, ADCB Asset Management

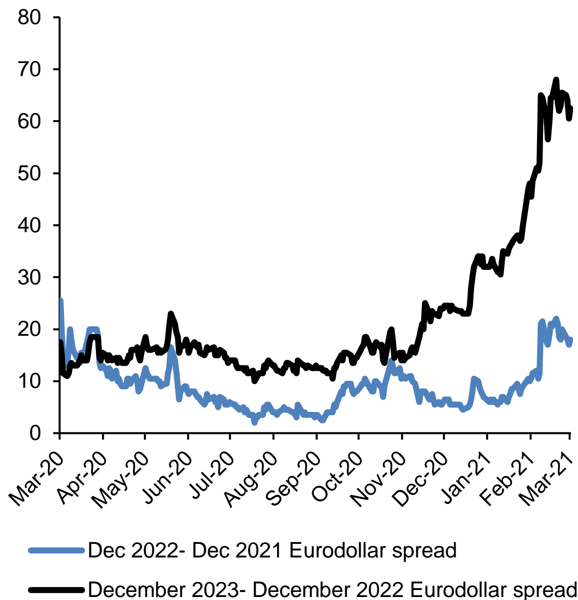
Chart 6: Markets got it right in the past?



Source: Bloomberg, ADCB Asset Management

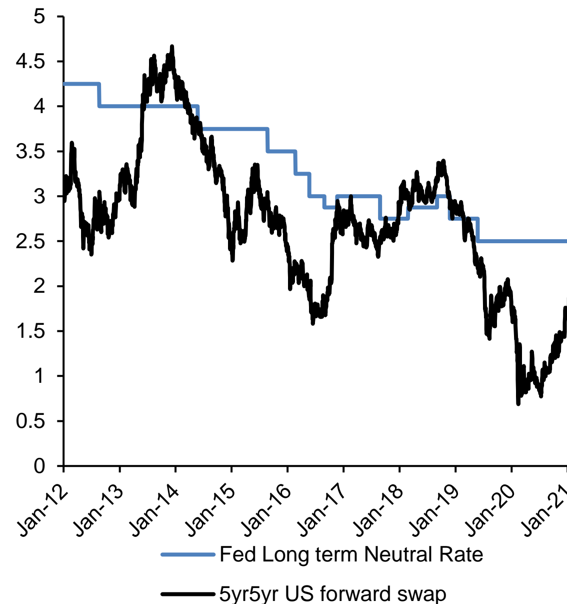
Separately, the rates market has started to aggressively price in rate hikes in the next two years. This again points to the market's doubt on Fed's current monetary policy. In the latest Fed's Dot plot there was no material change with the median rate projections pointing to no rate hikes through 2023. As against the Fed's Dot plot, the rates market is pricing in almost three rate hikes in 2023 alone (Chart 7). The 5yr5yr rate has also crossed the Fed's long-term neutral rate (Chart 8). Typically this acts as a harbinger of an upcoming monetary tightening cycle (in 2013 during taper tantrum and in 2018 before Fed rate hikes). However, the Fed is likely to be patient in announcing an exit from its loose monetary policies, relying on actual incoming economic data rather than the progress in forecasts. Hence, market pricing of an aggressive rate hikes looks overdone.

Chart 7: Markets start pricing in three rate hikes in 2023



Source: Bloomberg, ADCB Asset Management

Chart 8: 5y5y US rate crossing LT neutral rate



Source: Bloomberg, ADCB Asset Management

Overweight on US treasuries still makes sense

Even with our expectation of increased interest rate volatility, we still believe that an overweight stance on US treasuries makes sense. The recent US economic data has been surprising on the downside and while this could be attributed to temporary weather conditions in parts of US, markets have so far ignored it. With most economic forecasts now starting to fully price in the improvement in future growth outlook, it is possible that we could see more downward surprises. The latest pick-up in yields also appears to be a lagged impact of the upward surprises seen in economic data in the second half of last year. If economic data continues to disappoint, then we could see a reversal of the optimistic growth outlook priced in the UST yields and also resulting in a push back of market expectations of rate hikes in 2023.

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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