26 February 2021
For Client Use

Investment Event

Rising bond yields and market views

Government bonds have sold off sharply in recent days, especially US Treasuries

This market action has come amid investors pricing in a brighter global economic outlook and inflation concerns

Our views

Prospective returns for Treasuries have improved with increased scope for them to act as an effective diversifier in portfolios

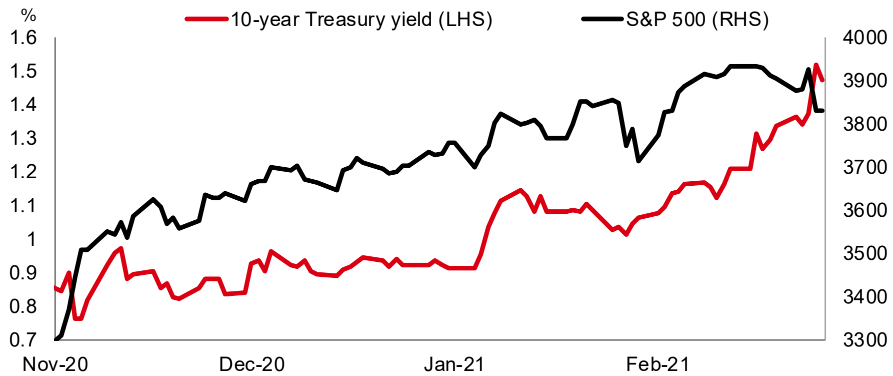
The risk of a bond market tantrum, as seen in 2013, is limited by potential intervention by central banks

Nevertheless, given current market pricing, higher bond yields pose a threat to equity valuations. Some relative caution on US equites is justified

US Treasury yields spike

Longer-dated US treasury bonds sold off sharply on 25 February, seeing 10-year yields rise 22 basis points to 1.52%. 10-year yields are up around 60 basis points in 2021 alone (Figure 1).

Figure 1: US 10-year Treasury yields and S&P 500



Source: Bloomberg. Data as of 26 February 2021

Whilst the sharp intra-day moves were triggered by weak demand at a government bond auction, broader moves in recent weeks have been driven by a marked rise in optimism around the economic recovery in the US and associated concerns around inflation. There are three drivers for this:

- US President Biden's proposed USD1.9 trillion fiscal package (9% of GDP)
- A successful vaccine rollout which has seen 13% of the US population receive at least one jab, with the pace of inoculation faster than in the majority of the world.
- Positive economic data surprises in the US, especially in household consumption and housing activity

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There is more scope for US Treasuries to act as a reliable diversifier asset

However, other developed market government bonds still look unattractive

Intervention by central banks limits the risks of further major ructions in markets

Higher government bond yields pose a threat to equity valuations

The composition of US equity markets implies some relative caution is justified

Cyclical sectors can perform well in this environment despite higher bond yields

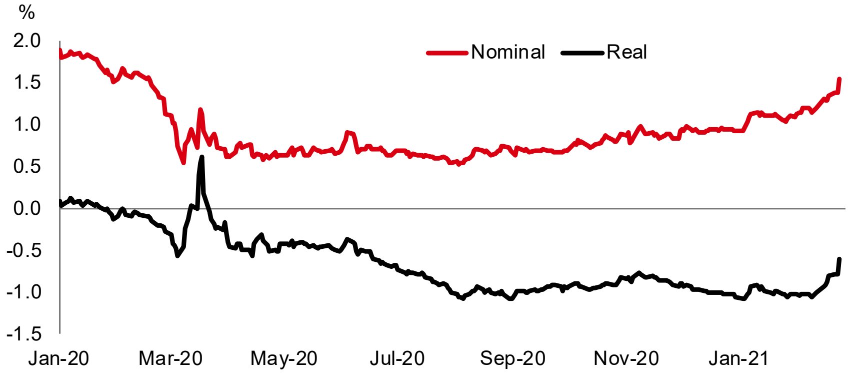
Commodities can act as an effective hedge against rising inflation risks

We think the potential upside to US high yield bonds has diminished

We need to monitor the impact of higher US bond yields on the US dollar

Notably, the majority of the recent rise in longer-dated yields has been due to a pickup in the "real yield", i.e. the bond returns after accounting for inflation compensation (Figure 2). This is despite the US Federal reserve reiterating that policy interest rates are likely to remain lower for longer, which has kept shorter-dated Treasury yields pinned at historically low levels.

Figure 2: US real versus nominal 10-year Treasury yields



Source: Macrobond. Data as of 26 February 2021

Indeed, the recent sharp rise in yields sparked a sell off in global equity prices, particularly in the US, that has benefited from ultra-low interest rates since the significant monetary policy easing enacted at the start of the pandemic (Figure 1).

Market considerations

Higher global government bond yields have a number of potential implications for our investment strategy views:

Bonds

- Prospective returns for **US Treasuries** have risen, and we think higher yields increase their ability to act as a reliable diversifier asset (for example in a scenario of disappointing growth outcomes). Treasuries are now offering us a reasonable premium for bearing risks related to future increases in interest rates and inflation (the "bond risk premium")
- Valuations for **other developed market government bonds** have also improved, but not by as much as for US Treasuries. We also estimate that the bond risk premium remains negative in bunds, gilts, and Japanese government bonds. This means that in effect we are being penalised for owning bonds relative to cash. We remain underweight in these markets, and continue to prefer US Treasuries for now
- For the time being, we think the risk of a **bond market tantrum, as seen in 2013, is limited by potential intervention by central banks**. They are likely to remain as dovish as possible at this stage of the economic recovery, which ultimately should cap bond yields. **This limits the risks of further major ructions in markets more widely**

Equities

- As we have previously communicated, the rally in risky assets over recent months has resulted in "hyper-sensitive" markets. In this context, **higher government bond yields pose a threat to equity valuations**
- Equity markets which have greater weights to "growth" stocks which are expected to see earnings growth further out into the future are particularly vulnerable to higher rates (as those earnings need to be discounted by current risk-free rates)
- This implies some relative caution on **US equities**, although we still believe this market ultimately benefits from its exposure to quality names, mega-cap tech, and the digital economy. US stocks also offer diversification properties in a scenario of a disappointing economic recovery
- Higher bond yields reflect investors pricing in a brightening outlook for the global economy. We also think the scope for pent-up demand to be unleashed later this year could be somewhat underestimated by the economic forecasting community. With this in mind, we think **markets exposed to cyclical sectors** (financials, industrials, materials) can continue to perform well even as bond yields rise. Value stocks can also do well in this environment

Other assets

- In a world of increasing upside risks to inflation, **commodities** linked to the economic cycle such as industrial metals and oil can add diversification to our portfolios. Gold can also act as an effective inflation-hedge, but is more sensitive to rising real interest rates and falling geopolitical uncertainty
- For **US high yield corporate bonds**, market action over the past few months has compressed spreads. This means that the credit risk premium (the reward for owning credits over government bonds) has fallen. Upside in this asset class seems more limited given current pricing and some remaining uncertainties on the default outlook
- We also need to monitor how widening interest-rate differentials between the US and the rest-of the world could put upward pressure on the **US dollar**. For the time being, however, with the Fed remaining dovish and US deficits wide, we think there is still scope for mild USD weakness ahead, especially against EM currencies (especially global growth-sensitive and commodity exporting EMs)

Our investment strategy views are currently under review ahead of upcoming investment team meetings and our finalised views will be communicated in due course.

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