WILSONS

Inflation up, bond yields down – what gives?

Our weekly view on Asset Allocation

21 June 2021

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Why have bonds rallied?

After a sharp (c80 basis point) sell-off in the first quarter (one of the fastest in history), bond yields have surprised the consensus by falling (c30 basis points peak to trough) in the second quarter. The US bond market has led the decline, although the Australian bond market has seen a similar pattern.

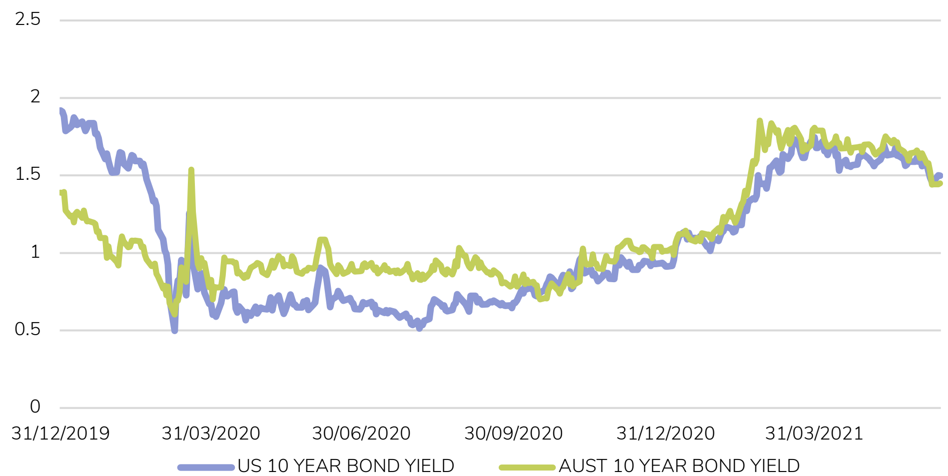
The decline in US bond yields is interesting in the context of the two most recent US inflation (CPI) readings, which have both been significantly higher than expected. Indeed, the rate of headline inflation at 5% is the highest in almost 13 years, while core inflation moved to a 40 year high based on the (April and May) month on month rise.

The surprising rally in bonds has supported further gains in global equities, and in particular, has encouraged a swing back toward the IT sector over the past month or so.

So, why have bonds rallied in the face of high inflation readings? Is the bond market telling us something about the growth and/or inflation outlook? Or is the decline in bond yields due to transitory technical factors?

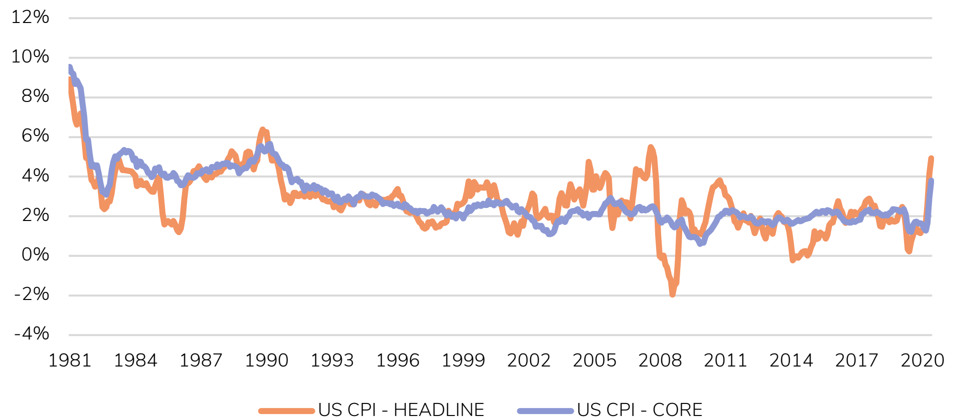
We believe a number of factors are likely at play in the countertrend bond rally this quarter.

Exhibit 1: US and Australian bond yields have drifted lower in Q2 despite a sharp lift in US inflation



Source: Refinitiv, Wilsons

Exhibit 2: US CPI inflation has spiked in the last 2 Months



Source: Refinitiv, Wilsons

Extreme market positioning

Bonds were likely "technically" oversold by the end of the first quarter. The 83 basis point lift in the US 10-year bond yield in Q1 was one of the fastest moves in the past decade, and investor positioning/sentiment became very bearish very quickly. It is not unusual to see a countertrend move in these circumstances where positioning and sentiment become extreme.

"Relative" value had become attractive

US and Australian long bond yields are substantially higher than comparative yields in Europe and Japan. This gap became even starker in the Q1 bond sell-off. This likely saw buying interest re-emerge from overseas investors. In addition, as longer-dated yields rose, the long end of the yield curve became more attractive versus the (anchored) short end, leading to some renewed buying of long-dated bonds by both global and domestic investors.

More mixed economic data flow in Q2

After a very strong rebound, economic data has also been more mixed in recent months. Most importantly, the previously sharp US labour market recovery has slowed down significantly. While the overall tone of data releases has been reasonably solid, a fair range of economic indicators have missed expectations. This has likely eased market concerns around the potential for an overheating US economy and provided renewed support to the bond market.

Lower US treasury issuance in second quarter

Finally, Q2 treasury bond issuance has been light (cUS$70bn) in comparison to the front-loaded issuance seen in Q1 (cUS$320bn). At the same time, the Fed has continued to purchases treasuries at a steady US$80bn a month via its QE programme. This shift in the short-term supply/demand equation likely provided a net bid for bonds in Q2; however, bond issuance will re-accelerate over the remainder of 2021.

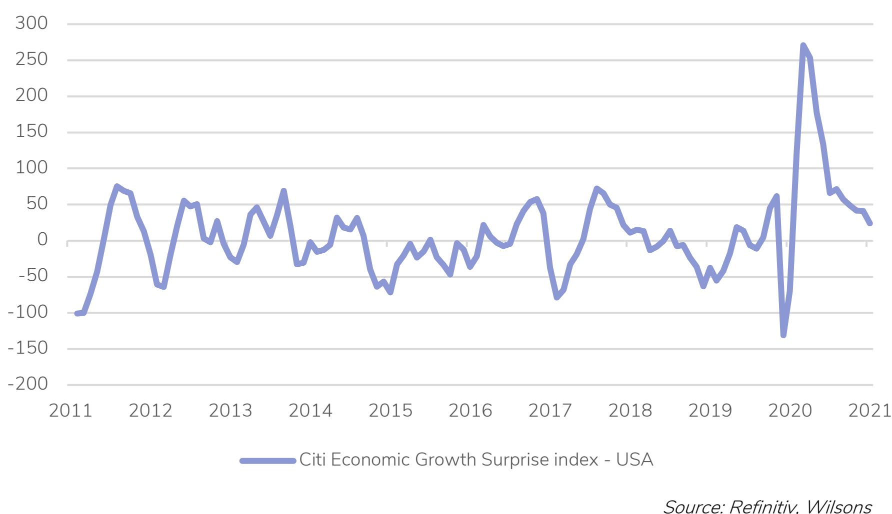
The Fed is in control of the bond vigilantes for now

These factors, in combination, arguably go a fair way in explaining the surprising move in bonds in Q2. However, the move down in yields is arguably still somewhat puzzling given the quantum of the inflation surprise seen over the last 2 months. Certainly, the Fed has been clear that it perceives the recent sharp increase in inflation as transitory. Judging by the bond markets performance in Q2, investors believe the Fed. Although, one may argue that the bond sell-off in Q1 had already priced in a decent pick-up in inflation. Inflation expectations embedded in inflation-linked bond pricing had already moved significantly higher, and therefore the April/May CPI spike had already been at least partially "priced".

Exhibit 3: The US spread to European yields was close to record wides at the end of Q1

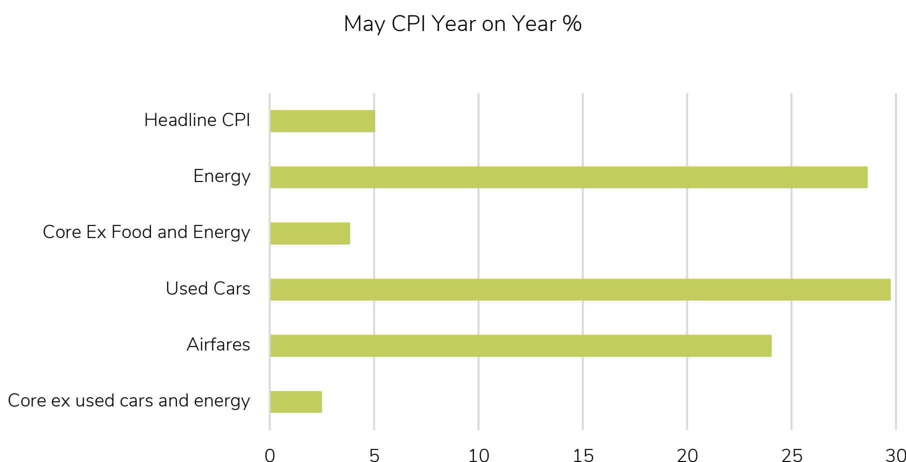
Source: Refinitiv, Wilsons

Exhibit 4: Positive economic data surprise has faded in months



Source: Refinitiv, Wilsons

Exhibit 5: A few extreme categories are skewing the CPI picture



Source: Refinitiv, Wilsons

The Fed does appear to have successfully convinced bond investors that an inflation uptick will not shift its resolve to maintain an ultra-accommodative monetary policy stance until the labour market recovery shows significant progress. While we don't doubt the Fed's resolve to keep policy easy for some time, details from the Fed's June meeting this past week suggest the Fed's policy view is shifting at the margin.

The Fed revised up its inflation and economic growth projections for 2021. Median real GDP is now 7% versus March's 6.5%. In addition, the median estimate for headline PCE inflation was revised up by 1 percentage point to 3.4%, while the core PCE inflation forecast was increased to 3.0%.

In accordance with these changes, the updated Fed funds rate "dot plot" showed a majority (13 of 18 members) now expect at least one rate hike before the end of 2023, compared to the previous guidance for the first-rate hike in 2024.

In the subsequent press conference, Chair Powell acknowledged that the effect of supply bottlenecks on prices "have been larger than anticipated" and that there is "the possibility that inflation could turn out to be higher and more persistent than we expect". Powell also noted that the committee "would be prepared to adjust the stance of monetary policy" in response to stronger inflation. Additionally, his comments suggested that tapering talks have been initiated, though Powell underscored that any changes would be communicated "well in advance".

The communication was a moderately hawkish surprise for markets. The 10-year Treasury yield increased 8 bps to 1.58%, moderately higher in comparison to the recent lows of 1.45%. However, this is still well down from the late March highs of 1.75%.

QE tapering discussions have begun

Fed Chair Powell communicated that the tapering discussion has now begun and will likely continue in future meetings. This was a change in tone relative to the April press conference when he emphasised that it was not the time to have this debate

We are still some way off until tapering is actually announced

Chair Powell also said that reaching "substantial further progress" is still " some way off". This suggests that the actual taper announcement is not imminent, despite the debate already kicking off.

We expect the formal taper announcement to be made, at the earliest, at the September meeting and, at the latest, at the December meeting, with actual tapering (of bond purchases) likely starting in January 2022.

We may see a stronger signal on tapering during August at Powell's Jackson Hole speech (27th/28th) or at the September (21st/22nd) meeting. This signal would likely mention that the economy is "on track" to achieve substantial progress.

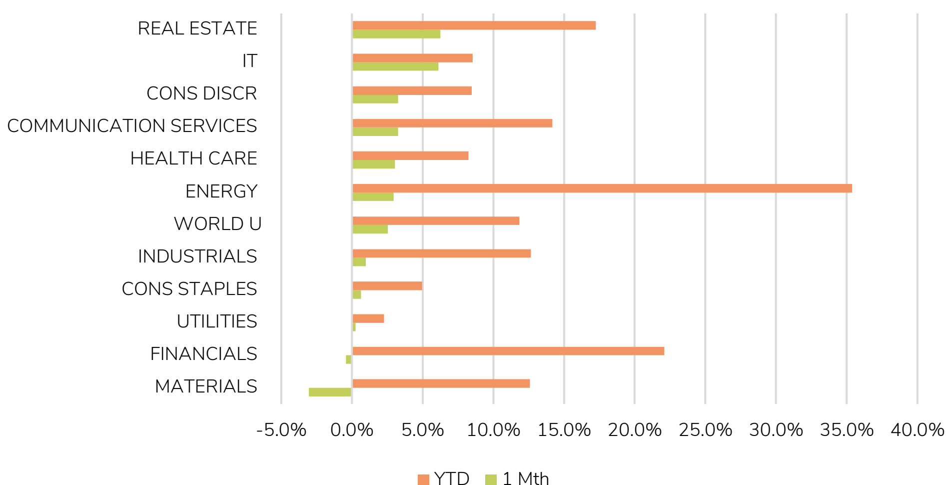
Bond sell-off should resume later in H2

We expect renewed upward momentum in yields potentially around August/September as tapering guidance becomes clearer and the US labour market recovery re-accelerates, helped by schools reopening and generous supplementary unemployment benefits rolling off. This may pose a headwind for equities, but we think it can largely be offset by sustained earnings momentum.

The likely firming of tapering guidance in coming meetings has been well flagged and should not trigger a 2013 style "taper tantrum" but should combine with a more evident labour market recovery and somewhat sticky inflation to push yields to moderate new highs for the year.

As discussed in our global vaccination update recently, global reopening is not without challenges, but bonds do not look attractive, particularly after the Q2 rally. Inflation will ease from current elevated levels on a 6-12-month view. Still, we expect a higher inflation trend than seen in recent years, at the same time as global growth becomes increasingly synchronised. We retain a sizeable underweight position in fixed interest and a moderate overweight in equities supported by an overweight in alternative assets. Our 6-12-month A$ view remains moderately positive though recent softness could persist near-term. We still prefer selected cyclical sectors and cyclical markets over growth/defensives, though some of the stronger performing cyclical areas may be due for a decent pause.

Exhibit 6: World sectors (ranked by 1 month performance) - lower bond yields have helped IT rebound



Source: Refinitiv, Wilsons

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All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

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