ARDEA Investment Management

10-May-2022

# Monthly Market Musings: Nowhere to hide

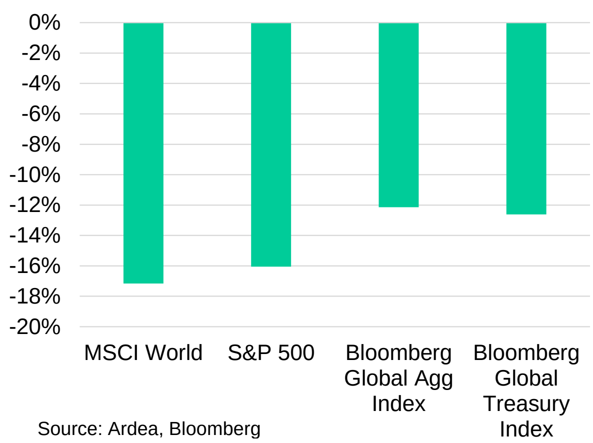
- Investors have few places to hide amid a synchronised sell-off in bonds and equities.
- Recent long-term yield moves reflect higher for longer rates risk and increased US term premia.
- Higher yield levels, slower growth and weaker equities can eventually entice investors back to bonds, but inflation dynamics are still a major a concern.

## A sell-off in bonds and stocks

The historically poor performance of bonds continued over the last month. The 60bp increase in the US 10y yield in April was the largest monthly increase since 2009. Other markets such as Europe have seen similarly large moves, taking 10y yields in many markets to the highest levels in seven years. This sell-off builds on a horrible Q1 for bonds - the worst in over 30 years for some benchmarks. Year-to-date (as of 9-May), the Bloomberg Global Aggregate Bond Index is down 12%.

Bonds have not been a safe place to hide from weaker equity markets. After staging a brief rebound over the second half of March, equities slumped through April and early May. Year-to-date, major indices are down as much as 17%.

Chart 1: YTD bond and equity benchmark performance

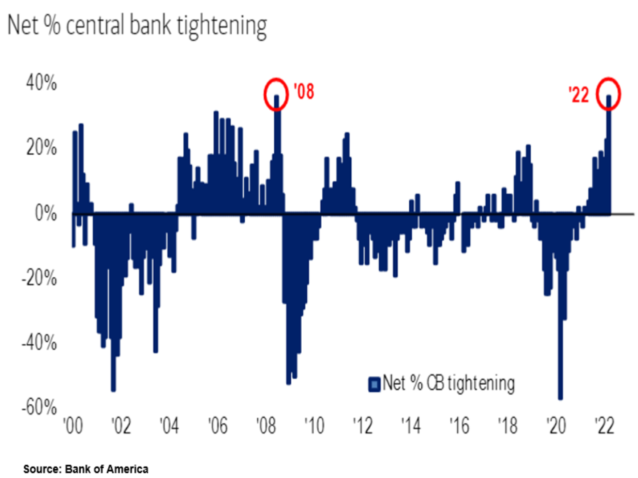



Source: Ardea, Bloomberg

The high starting point for valuations has played a role in the recent correction. Still, this pace of repricing is historically significant. Investors with a long timeframe would point to similarities with the 1970s, where stagflation dominated. Recent developments have focused market participants on this risk, notably:

- The most aggressive Fed tightening cycle since 1994, undermining confidence in a soft-landing for the US economy.
- A broadening of global central banks lifting rates (the RBA joined global developed market peers in May). Bank of America note there is now the highest net % of central banks tightening since 2008 (Chart 2).

Chart 2: Net % of global central bank tightening




- Prolonged surging inflation that continues to exceed forecasts and central bank targets.
- A slowdown and lockdown in China weighing on both the outlook for global growth and

supply-side price pressures.

- The Ukraine war exacerbating commodity price pressures and risk of an energy crisis in Europe.

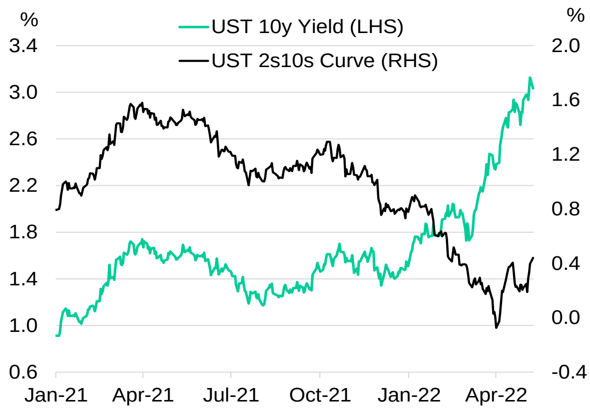
## Higher for longer rates and real yields

Beneath the surface of higher yields over the last month, there are two trends worth highlighting:

**1) The US bond sell-off moves further out the curve**

In our last note (see here), we detailed the rapid pace of central bank tightening factored into the front end of yield curves and the implications of an inverted US 2s10s yield curve for recession risk and equities. Through central bank tightening cycles, flattening led by higher front-end yields is the norm. This trend is likely to re-establish at some point. But markets rarely move in a straight line. After briefly trading inverse in late March, the US 2s10s curve has steepened to 40bp and other markets have seen a notable rise in long term yields.

Chart 3: US 2y vs 10y Curve and 10y yield



Source: Ardea, Bloomberg

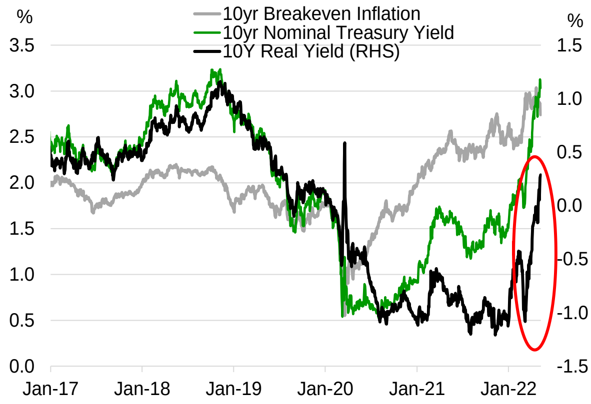
This long-end led sell-off over the last month reflects:

- Restrictive monetary policy already priced into the very front-end.
- Investors having less confidence policy rates will be cut back to lower levels again in the period after policy tightening because of high uncertainty over the inflation trajectory and central bank reaction functions.
- Investors are demanding a higher term premium to compensate for a faster pace of Fed quantitative tightening (see last month's note for details). Treasuries have cheapened vs OIS (cash rate swaps) and quantitative models suggest term premia is rising.

**2) Rising real yields**

Since March, the bond sell-off has seen global real yields keep pace with higher nominal yields. The US 10y real yield – a key rate for global markets – has risen from a low of -1.08% in early March to now be +0.33%. That puts the 10y real yield in positive territory for the first time since pre-Covid. Sharply rising real yields pose a greater threat to risk assets than a drift higher in long term nominal yields. Pressure from rising yields is occurring much earlier in this cycle than in the last Fed tightening cycle. It wasn't until the 10y real yield was closer to +1.0% in 2018 that equities experienced a sharp correction.

Chart 4: US 10y yield breakdown



Source: Ardea, Bloomberg

## What could drive a turnaround in bonds?

In previous cycles, the peak in longer term yields has typically occurred much further into the cycle. However, given the pace of the recent rise in bond yields, weaker stocks and some models and investor surveys pointing to rising recession risk (as outlined last month), the peak in yields could be seen earlier this time around.

We identify three key catalysts that could ultimately drive renewed support for bond markets.

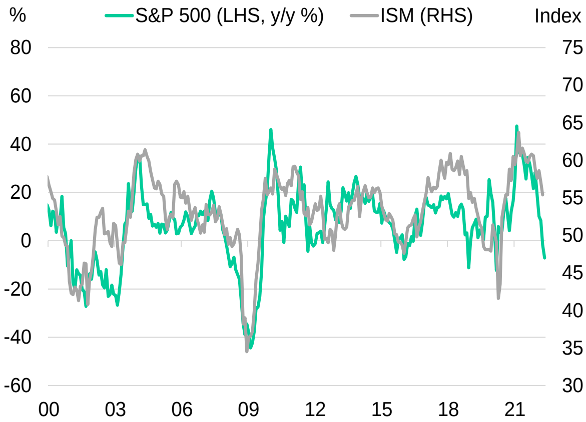
### 1) Inflation data pulse turns lower

As discussed in our last note, bond yields could rise significantly until inflation dynamics start to turn. The sheer magnitude of inflation pressure and forecast misses over the last year has shifted market psychology. Many market participants have been burned by inflation forecasts and now need to see hard evidence of a turn lower in inflation data before being convinced of improved value in bonds. Recent data releases show inflation is still surging. There is a risk that supply-side pressures worsen further in the near term in the wake of recent disruptions in China.

### 2) Risk asset correction deepens significantly

A sharp enough correction in risk assets could drive flows back into bonds. As discussed in last month's note, significant bear markets in equities tend to be seen when recession risks are nearer. On some basic measures, the equity correction of the last month is starting to price a significant downturn in growth (sub-50 in the ISM, Chart 5).

Chart 5: ISM survey vs S&P 500



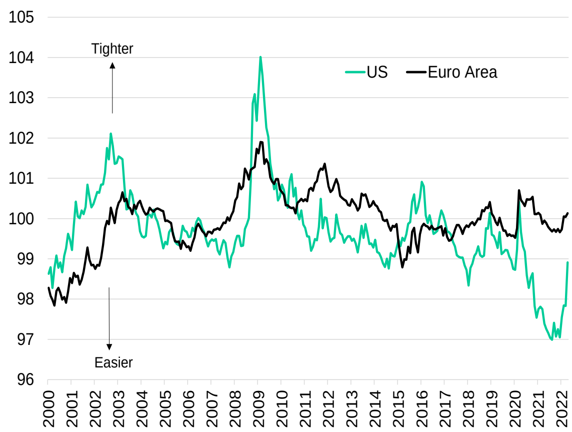

Source: Ardea, Bloomberg

Picking the tipping point for bonds from weaker risk assets is tough while inflation is rising sharply. The rebound in bonds in the last Fed tightening cycle in 2018-19 was ultimately bolstered by the Fed reversing course with tightening plans amid pressure from crumbling risk assets. An April Bank of America survey found many global fund managers expect a so-called Fed "put" on the S&P 500 index is around 3637, implying another 9% fall from current levels (or some 24% lower than start of 2022 levels).

However, based on recent statements, major central banks are unlikely to give-up the inflation fight so early in the tightening cycle. Fed policy is still in highly accommodative territory. In Europe, ECB officials are still signaling policy tightening in July in the face of more significant growth headwinds than the US. In Australia, the RBA has only just began lifting rates and suggested there is plenty more hikes to come.

Central banks tend to take a much bigger picture view than market participants on overall financial conditions, which are tightening on the combination of higher yields, wider credit spreads and weaker equities. Given the starting points for both bonds and risk assets, financial conditions are arguably still not tight from a longer-term perspective (Chart 6).

Chart 6: GS Financial Conditions Index – US and Europe




Source: Ardea, Bloomberg, Goldman Sachs

### 3) Higher yields become more appealing to investors

Notwithstanding year-to-date volatility, in a multi-asset portfolio context, high quality government bonds typically play a defensive role due to their lower risk characteristics. There is usually a trade-off here because the lower risk benefits come at the cost of lower returns.

In recent years this opportunity cost has been high because the ultra-low interest rate environment evaporated the returns available from defensive investments. While the recent correction in bond markets drives capital losses, there has been substantial further flight out of bonds.

However, the dial may start to turn soon as valuations now look more enticing. Yields are now at the highest levels in some markets for seven years or more and previously negative yielding markets such as Europe now offer positive yields. The overall share of negative yielding debt in the Bloomberg Composite Index has collapsed from over 30% to 5% (Chart 7).

Forward interest rate curves in many markets are priced for rates moving well into restrictive territory, based on central bank and consensus economist views on neutral policy. The increased probability of overtightening in policy is ultimately a positive for duration, albeit difficult to time in the short run while inflation uncertainty is so high.

Chart 7: Share of negative yielding debt in the Bloomberg Global Aggregative Index


Source: Ardea, Bloomberg

This material has been prepared by Ardea Investment Management Pty Limited (Ardea) (ABN 50 132 902 722). Ardea is the holder of an Australian financial services licence AFSL 329 828 and is regulated under the laws of Australia.

This document does not relate to any financial or investment product or service and does not constitute or form part of any offer to sell, or any solicitation of any offer to subscribe or interests and the information provided is intended to be general in nature only. This should not form the basis of, or be relied upon for the purpose of, any investment decision. This document is not available to retail investors as defined under local laws.

This document has been prepared without taking into account any person's objectives, financial situation or needs. Any person receiving the information in this document should consider the appropriateness of the information, in light of their own objectives, financial situation or needs before acting.

This document is provided to you on the basis that it should not be relied upon for any purpose other than information and discussion. The document has not been independently verified. No reliance may be placed for any purpose on the document or its accuracy, fairness, correctness or completeness. Neither Ardea nor any of its related bodies corporates, associates and employees shall have any liability whatsoever (in negligence or otherwise) for any loss howsoever arising from any use of the document or otherwise in connection with the presentation.