PENDAL

Bond, Income & Defensive Strategies

Newsletter

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Winter is still coming

October was dominated by US pre-election jitters. A resurgence of Covid-19 cases in the northern hemisphere – leading to a new phase of lockdowns in Europe – didn't help risk sentiment. All the while, fiscal stimulus deadlock in the US continued. While developed equity markets retraced as much as 10% off their intra-month highs, the main frustration for fixed income portfolios this month was the lack of any offset playing through in core bond yields. In fact, on various vaccine hopes and a building conviction that large fiscal stimulus would be waiting around the corner in the US no matter the election outcome, the move higher in US bond yields also led the bond sell-off in markets like Australia.

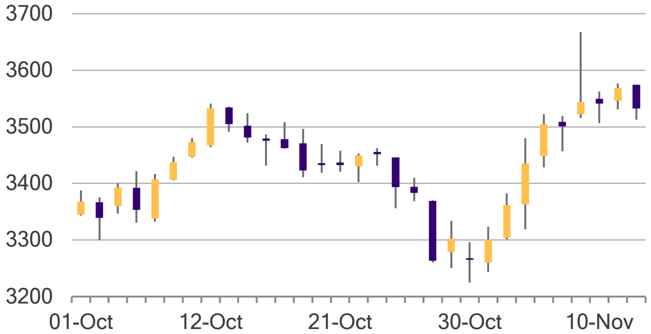
At these low yield levels, the sensitivity of bonds to equities, and in particular a mega tech-dominant benchmark index such as the S&P 500, seems far more muted. Instead, the US dollar has been more reactive to overall risk-on and risk-off sentiment.

US election day itself saw some decent back-and-forth in price action. A race that was far closer than expected by pollsters saw yields and equity markets lower intra-day. As it became clearer that Biden would win without a "Blue Sweep" equities and bonds were off to the races. Equity markets rallied simply because uncertainty fell away. Bonds rallied because the fear of massive bond issuance to finance massive stimulus had been dialled down.

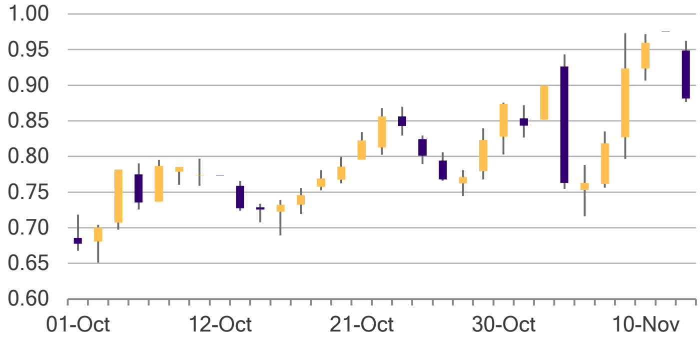
Of greater impact is the news that Pfizer's Covid vaccine is on the way, with 90% effectiveness shown in testing so far. The immediate market reactions were well understood: equities up, yields up. But inconsistency since the knee-jerk reaction has seen a sizeable retracement in the equities reaction, while bond yields have continued to march higher.

Chart 1
Long tails and unloved bonds

Long tail left behind in the initial equities rally
SP500 E-Minis



Bond yields continued to drift higher
US 10y treasuries %



Source: Bloomberg

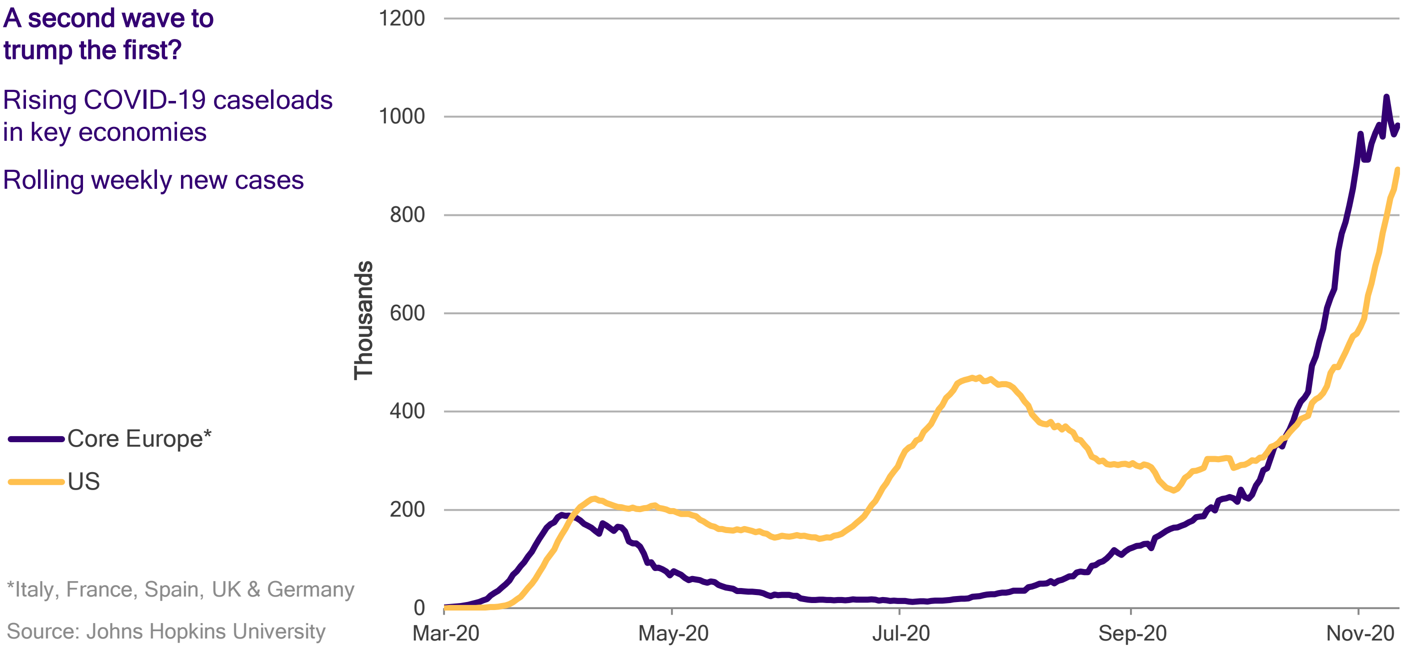
There is a big gap between disaster and reflation

There is concern now of a sustained sell-off in bond yields propelled by all this good news. No doubt the vaccine news is indeed good, especially if the effectiveness of this vaccine is really 90% as the initial tests show. High effective rates increase the efficiency of any vaccine because it needs to reach fewer people per population for that population to gain herd immunity. However, as we mentioned in last month's newsletter, what is good news objectively may not always be good news as far as markets are concerned. In relation to the good vaccine news, the offsetting effect is that of lesser fiscal stimulus. For the US in particular, the more likely a speedy delivery of an effective vaccine, the less likely the passage of a large fiscal stimulus bill. This is still a far better outcome than no vaccine and no significant fiscal stimulus. Surely that would be enough to send the US into a double-dip scenario in the next few winter months and rapidly climbing Covid numbers.

Chart 2
A second wave to trump the first?

Rising COVID-19 caseloads in key economies

Rolling weekly new cases



*Italy, France, Spain, UK & Germany

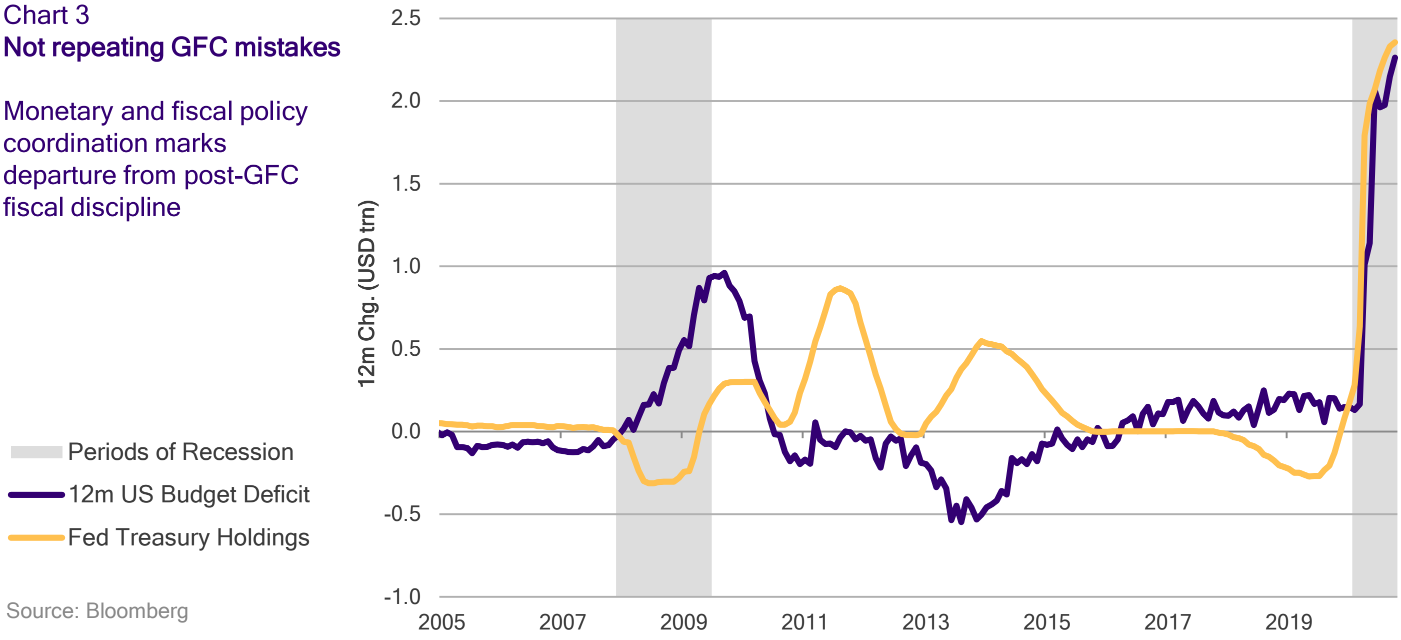
Source: Johns Hopkins University

This combination of likely vaccine with lesser fiscal stimulus is nowhere near as positive a scenario of large fiscal stimulus pumped alongside the delivery of an effective vaccine. This latter scenario is what, in our view, would lead to a credible reflationary environment. Until then, it is still about the path of recovery. The implication for bond yields are very different in these scenarios as they entail very different central bank responses.

As long as economies remain in recovery phase, the job of the central banker in the developed world is to support whatever fiscal firepower gets unleashed by governments, being careful not to undermine fiscal policy with any tightening in monetary policy. For the Fed, the Average Inflation Targeting (AIT) framework allows them the flexibility to perform this kind of subservient role. At their effective lower bounds (ELBs), this is the most that monetary policy can do. The combination of tools involve strong forward guidance of a commitment to stay at these zero rates for a long time to come, as well as QE and YCC to help anchor the shape of the curve and prevent any over-steepenings.

Chart 3
Not repeating GFC mistakes

Monetary and fiscal policy coordination marks departure from post-GFC fiscal discipline



Source: Bloomberg

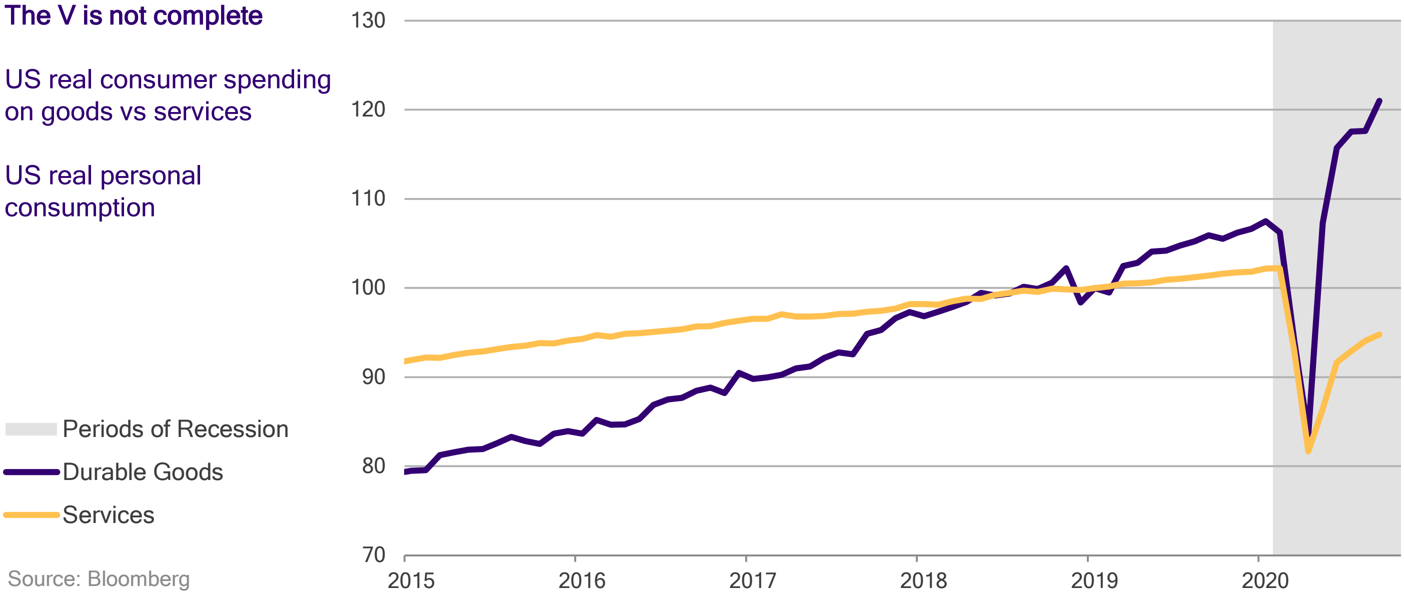
Central bankers still need to be seen as not completely losing their autonomy over monetary policy. Although their ability to deliver a positive stimulant pulse at these low rates is null, they need to be able to deliver tightening if the fiscal stimulus and an eventual control over the pandemic succeeds in closing output gaps and raising inflation. That reflationary scenario is every central banker's dream right now. The Fed hiking cycle against the Trump tax-cut era of 2017-18 feels like a lifetime ago.

A large part of the recovery so far has been about the industrial and manufacturing sectors of most developed economies.

Chart 4
The V is not complete

US real consumer spending on goods vs services

US real personal consumption



Source: Bloomberg

Services need to catch up more to soak up the slack in labour markets. With a vaccine on the way it will only be a matter of time before this gap is able to close more meaningfully. However, timing matters a lot here.

The fiscal stimuli delivered to date, both for the US and in Australia, have been a great source of income support during the worst of the Covid crisis. Fiscal stimulus focused on these expense items helped keep workers in touch with employers and allowed a much better than initially forecast outcome on aggregate unemployment levels. However, with recent positive vaccine news and no Blue Sweep in the US election, the fiscal stimulus is likely to become far less generous, focusing more on infrastructure and other investment items. Not only is the fiscal impulse getting smaller, the multiplier is also likely to reduce. In the meantime, the coming northern hemisphere winter suggests there is significant gap risk to consider if vaccine news disappoints in the future. Imagine a winter with no vaccine, a slowing fiscal impulse and a much more vicious wave of Covid. Suddenly (albeit temporarily) we're staring at the double dip and disaster scenario again.

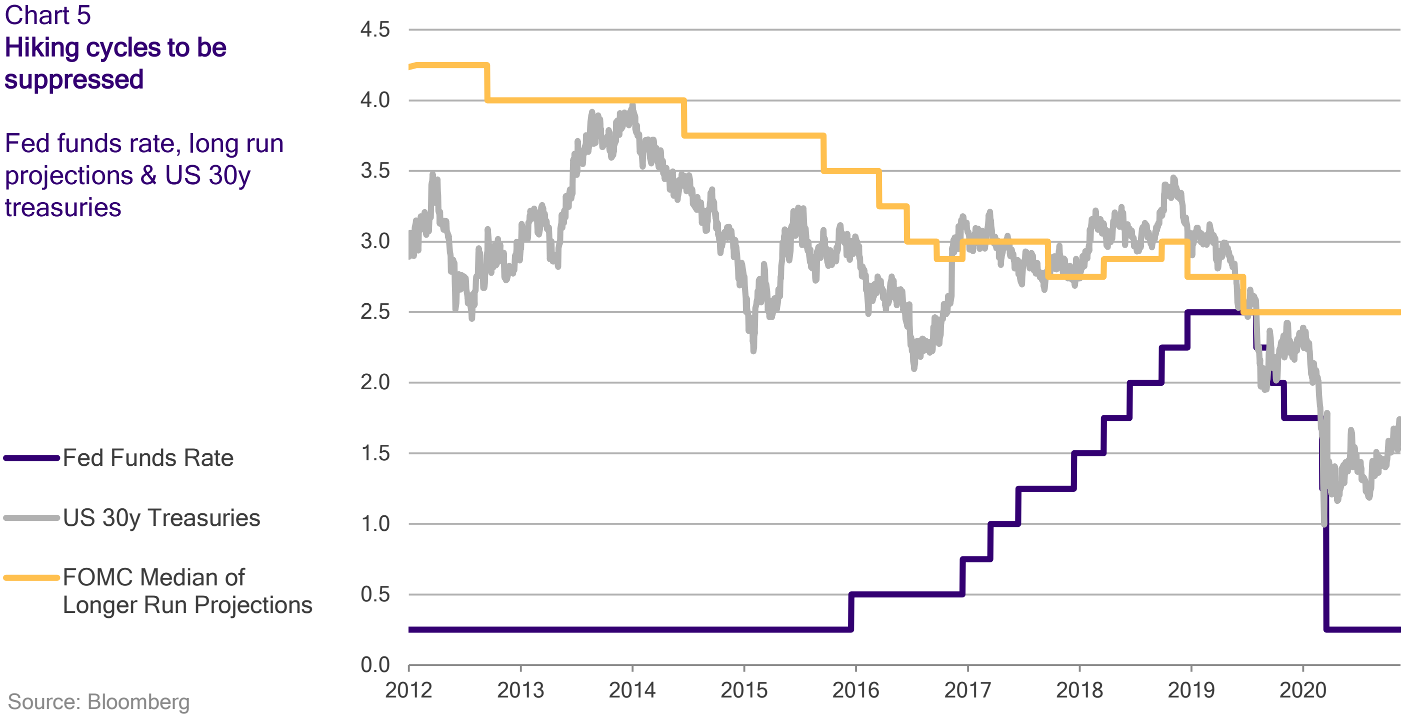
Can we still feel bullish about bonds?

The conviction of bond bulls has been given a fair bit of shaking in recent weeks. This is especially so after a double-dose good news in the end of US election uncertainty and a vaccine arrival in the hopefully not-too-distant future. The recent move higher in yields has been led by the US as a reaction to the vaccine news. This is understandable. Not only do US rates typically set the tone for global rates, but a vaccine will bring a greater positive economic impact in countries where the virus has been harder to contain versus places such as Australia.

However, given that expectation of a 2021 vaccine was already largely in the consensus narrative, as far as ten-year bond yields are concerned, we would argue that a large part of the good news was already factored in by valuations. We revert back to thinking about the Fed's likely path of actions given what we know today. The general trend of the Fed's terminal dot plots has seen the "peak" Fed Funds rate come down over time. Even during the most recent hiking cycle, this terminal peak rate simply drifted sideways. This is consistent with the broader theme of secular stagnation – over cycles it takes a lower and lower neutral rate to sustain a given level of growth and inflation.

Chart 5
Hiking cycles to be suppressed

Fed funds rate, long run projections & US 30y treasuries



Source: Bloomberg

We already have strong forward guidance from the September FOMC suggesting the Fed will not be looking to lift off from its zero bound for the next three years. If you take their AIT framework at face value together with their own inflation forecasts, it is more likely they don't lift off for the next five years. At the most extreme, you'd be forgiven for concluding that since central banks have been overly optimistic on their inflation forecasts now for a decade, they're more likely to stay at the zero bound for seven years or longer.

At a very simplistic level – and before making any assumptions about the term premia in rates – it's easy to see that the longer the Fed stays glued to the floor, the less that future potential rate hikes are able to push today's 10-year bond yield meaningfully higher.

If you're comfortable assuming that terminal peak policy rates will only come down further over time, it's all the more likely that 10-year bond yields will be anchored close to where they are today (if not meaningfully lower) until these central banks see an inflation problem in their rear-view mirrors.

Of course the markets may be much more forward-looking and assess the positive weight of the vaccine news as usurping the storms that lie ahead this (northern hemisphere) winter. But we think yields at these levels present a good buying opportunity. The markets may be so forward-looking that this winter's risks aren't even being brought into focus.

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