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CIO Viewpoint

Optimism-fuelled rise in yields poses challenge for Fed

Investment Solutions

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Bond markets are anticipating a sharp economic US recovery, reflected in yields that have tripled in the last six months. That has profound and immediate consequences for investors, but does not suit the Federal Reserve's timetable for winding-down asset purchases and lifting interest rates.

On 6 March, the US Senate approved the Biden administration's USD 1.9 trillion stimulus package, setting the stage for a boost to economic support programmes that equates to 8% of gross domestic product. A month ago, Treasury Secretary Janet Yellen said, "there's absolutely no reason why we should suffer through a long, slow recovery."

US yields began rising in mid-February in response to improving economic data and anticipation of higher inflation. The yield on benchmark 10-year Treasuries rose 7 basis points last week to more than 1.54%, three times the yield of 0.51% on 4 August 2020. On 5 March, the S&P500 closed around 2% lower than its record of 12 February. High equity markets, which have priced in a post-pandemic recovery for months, leave little margin for a monetary policy mistake.

Are we nearly there yet?

The Institute for Supply Management's February data showed last week that prices are at their highest levels since 2008 and its manufacturing measure recorded a three-year high, and its ninth consecutive month of expansion. There are also early signs of a recovery in services industries: total US unemployment fell slightly to 6.2%, with many of the new jobs recorded in the hospitality and leisure sectors. Commodities have also gained this year, with both oil and copper registering multi-year highs.

The Fed has consistently rejected the notion that recent price rises point to a sustained increase in inflation and describe rises as "transitory." The Fed wants to keep US monetary conditions accommodative with rates close to zero in anticipation of a broad economic recovery.

Fed Chair Jerome Powell continues to emphasise a full employment target. His objectives of maximum employment and average inflation at 2% "are highly desirable outcomes that would represent an economy that is very far along the road to recovery." Three months of limited job growth is "not very much progress," he added.

Stéphane Monier
Chief Investment Officer, Lombard Odier Private Bank

Key takeaways

- Rising bond yields reflect the improving economic outlook in the US
- The Fed may only intervene if markets overreact and won't start tapering asset purchases until it sees full employment and inflation on target
- Post-pandemic recoveries worldwide are normalising inflation, however, global competition and output gaps remain deflationary
- We started positioning portfolios for rising yields in September 2020 and see volatility offering opportunities to add more cyclical positions.

Two weeks ago, we wrote that we would not see sustained rise in inflation as long as economic slack persists. We estimate that at the current pace of recovery, the US jobs market would need another 2.5 years to return to its pre-pandemic employment levels. While this slack in the employment market persists, it will keep any more sustained price increases in check.

In the meantime, policymakers are happy to tolerate higher bond yields, as long as they reflect the improving economic confidence and outlook, based on vaccine programmes and more stimulus.

Communications and timing

Mr Powell's most effective weapon is communication. As recently as December, the Fed promised to keep its short-term policy interest rate close to zero through 2022. However, a 4 March presentation reiterating the Fed's outlook failed to persuade markets. For now, yield increases have not been enough to prompt a response from the Fed. That could change if the rises continue.

The Fed's shift to average inflation targeting is likely to fuel a higher premium at the long end of the bond curve since the approach implies more inflation uncertainty and the monetary policy reaction to rising prices. Given that would then require strong forward guidance from policymakers to steer shorter-dated sovereign debt, which also implies that the yield curve may steepen, though not to the levels seen in 2009 and 2011 in the wake of the Great Financial Crisis.

While the increase in bond yields poses a challenge for equity investors, it also reflects a more positive outlook for economic recovery. That is fundamentally positive for the underlying companies that the stocks represent. In which case, if handled carefully, an improving outlook for the economy should offset any 'tantrum' over an eventual reduction in monetary support.

The Fed continues to buy USD 120 billion of assets per month. Mr Powell would rather wait for the economy to show further signs of recovery before tapering this asset buying. Then, once that tapering process is complete, and the central bank's balance sheet is stable, he would start raising interest rates, referred to as the moment of 'lift off' without undermining growth. "The lift-off guidance is pretty specific and it will take some time to get there," he said last week.

Once this period of market volatility is past, and since the Fed only plans to start winding down its asset purchases in 2022, we believe that the first post-pandemic US interest rate hikes will not happen until 2023.

Watching closely

The rest of the world is closely watching developments on US markets. Inflation pressures are normalising everywhere as vaccination programmes roll out globally. However, excess capacity, output gaps, improving trade flows and international competition are all deflationary, leaving inflation lower than central bankers' targets from Switzerland and the eurozone to China.

The People's Bank of China (PBoC), for example, has promised no "sharp turns" in policy and warned investors about financial market bubbles abroad following loose long-term monetary policy. The central bank has already removed some liquidity from the banking system and we expect the PBoC to begin raising interest rates late this year. The PBoC is attempting to avoid creating asset bubbles, rebalancing the corporate debt market and reducing the economy's reliance on property development.

The economic recovery in Europe continues to lag the US. Still, the benchmark German 10-year Bund yield rose from -0.6% at the start of the year to -0.3% this month. Eurozone inflation has been below the European Central Bank's 2% target for

Key forecasts 2021

	2021 FY inflation forecast	GDP growth forecast	Key policy rate
US	2.0%	6.0%	0.25%
Eurozone	0.9%	4.3%	-0.50%
China	2.0%	9.0%	2.20%

Source: Lombard Odier calculations

much of the past eight years. In February it was unchanged from January, at 0.9%, according to Eurostat estimates.

The ECB's policymakers are scheduled to meet on 11 March. The ECB "should not hesitate" to increase its bond market purchases to restrain yields, board member Fabio Panetta said 2 March.

Positioned for recovery

Although the increase in yields has proven sharp, it did not come as a surprise and we have been positioning portfolios for a recovery over the last two quarters. In September last year, we increased our exposure to economically sensitive assets such as European, UK and emerging equities, and reduced duration-sensitive assets such as high-quality bonds and gold, which tend to suffer from higher long-term yields.

We see market volatility as opportunities to build on this pro-cyclical positioning, as long as the logic behind higher yields remains an improving macroeconomic environment.

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