Sanctum Wealth Management

Sanctum View

March 1, 2021

Can you Endure the Duration?

- **Bonds endure a tough month.**
- **Bond traders are sending an unambiguous signal to the Treasury that they do not see value in their paper.**
- **US government Bond yields could go a lot higher – 6% is justified by historical precedent.**
- **US 10 year government bond yields well above 2% look quite possible.**
- **Equities hit volatility but still making much more money than bonds.**
- **Rising commodity prices only increase the upward pressure on yields.**

You might also like our [Upgrades Everywhere] and [Equities Beat Expectations]. Click [here] to read them for free.

February was shaping up to be a more difficult month for markets anyhow, but in the final days, it served up a harsh reminder that it is still too early to sound the all-clear. As was the case last March, the US Treasury market was the first to suffer a very acute bout of volatility. Equity markets were shaken badly but have mostly maintained their poise despite a tough final week.

In fixed income markets, the epicentre of the flash tantrum was the belly of the US Treasury curve: maturities in the range of five to seven years. The 10-year Treasury touched a high of 1.61% before settling down to 1.40% at month-end.

Part of the reason for the sudden spike in yields was a very poor auction of 7Y Treasuries, in fact, the worst on record at a bid-to-cover ratio of just 2.04. This sent a poor signal to the market, causing a very sharp sell-off. The MOVE index, a measure of bond option volatility, jumped from 47 to 76, the highest since March 2020.

Bond traders are sending an unambiguous signal to the Treasury that they don't see value in their paper. Economists see vibrant US growth for the next two years and a spike in inflation to over 3.0% in the coming months. Meanwhile, the Fed shows little interest in tightening monetary policy, quite the opposite. Last week Fed Chairman Powell suggested that the Fed will stand pat in the face of rising inflation and the imminent passage of the $1.9 trillion spending bill in Congress.

The coming month could see a tense standoff between the market and the Fed. The market is likely to test just how far the Fed will allow long rates to rise and at what pace.

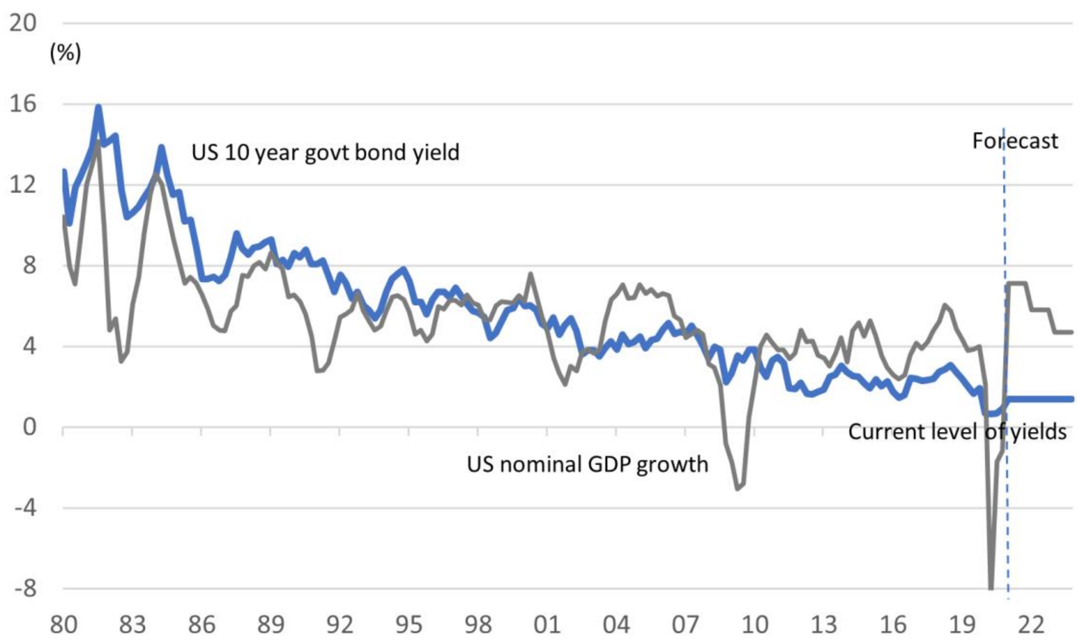
There is a massive disconnect between the level of the US government 10-year bond yield and forecast levels of nominal GDP growth in the coming two years. In part, it is because the Fed has not altered its policy stance even though the fiscal policy under President Biden is forecast to be much more expansive than previously thought.

Where should the US 10-year bond yield be now? Answer: a lot higher

In theory, there should be a relationship between the growth of an economy and the level of long-term interest rates. Chart 1 shows that there is no linear relationship but that they do track each other. So, let's consider several scenarios for gauging how high the US 10 year should be.

1. Scenario 1: US 10-year bond yield reverts to the long-term relationship with nominal growth. Since 1980 on average, the US 10-year bond yield has traded 50 bps below US nominal growth level. In 2021 the market expects 7.0% nominal GDP growth; hence the **US 10-year bond yield should be 6.6%!**
2. Scenario 2: US 10-year bond reverts the long-term relationship with nominal growth over the period since the US has heavily used quantitative easing. On average, the US 10-year bond yields has traded 100bps below the level of nominal GDP growth. Hence this equates to **a US 10-year bond yield of 6.0%.**
3. Scenario 3: The relationship between the US 10-year bond yield and growth is based on the long-term prediction for US nominal growth. Economists expect 1.9% real growth and 1.8% inflation hence nominal GDP growth of 3.7%. Take 100bps off based on the assumption of further QE, which equates to a **10-year bond yield of 2.7%.**

Chart 1: US 10 year government bond yield normally tracks US nominal growth



Source: Bloomberg and GCIO estimates

Our analysis suggests that the Fed would be seriously manipulating the markets if they didn't allow long term interest rates to rise by at least 100bps from here. The analysis begs the question that with fiscal policy having taken up a great deal of the policy strain to generate US GDP growth, one would expect the Fed to back off from the extremes of monetary easing. But how far is the Fed prepared to bend and adapt their policy?

Our very simple advice is to be wary of bond duration. Losses on high-quality bonds could easily wipe our future coupon payments for months to come.

Global equity markets had a volatile February, but MSCI World still managed to turn out a total return of 2.6%. The US S&P500 index was up 2.7% for the month, despite the nasty 2.5% drop in the final week. Much attention recently has been focused on the rotation to value and away from technology. For the month, the tech sector, as measured by the Nasdaq Index, was down 0.5%. In the last week of the month, it dropped by 4.9%.

Away from the US, the standout performer has been Japan, where the Nikkei rose 2.8% on the month, despite the sharp setback in the final week when the risk-off sentiment saw it give back 4.2%. Europe also recovered with the Eurostoxx 50 returning 4.5% for the quarter. The overall MSCI World Index is up 27.4% over the last year.

While suffering a bout of volatility like all the other asset classes, commodities are still rising strongly. For the month, copper spot prices were up 14.1%, and iron ore prices rose by 3.6%. Aluminum has not been as strong (up 61.9% and 94.6% respectively over one year), but rose 6.1% on the month, and is now up 28.35% over one year. The continued rise in commodity prices appears to be driven by the expectations of demand returning in China and other markets where COVID had a significant impact. These expectations, in turn, feed into the fears expressed in the bond market.

Gary Dugan
Johan Jooste
Bill O'Neill (Consultant)