MI2 Chart Point: Interesting Bond Charts

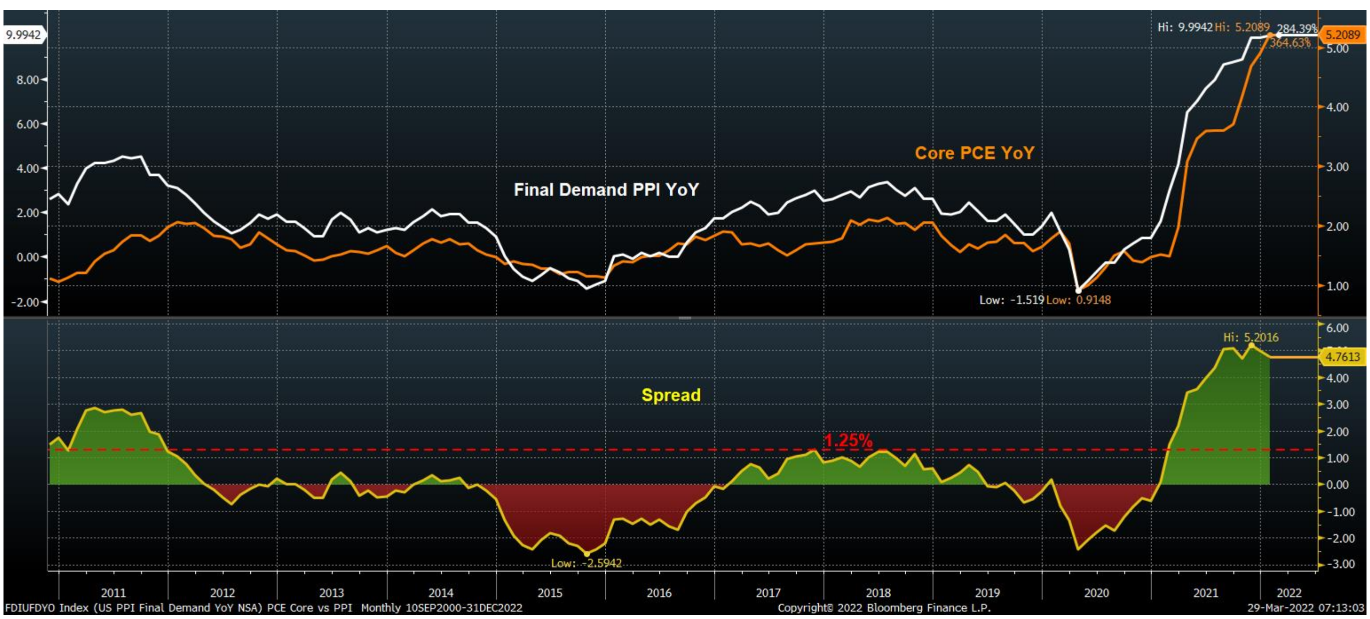
29th March 2022

Comment

Price action around quarter ends can be complicated to interpret. This is especially so in fixed income and FX as we approach the Japanese year-end. If it wasn't challenging enough, we also have a slew of event risk this week. On the data side, we have preliminary March European inflation and US PCE. As discussed in our last "Ask Me Anything Video" (10th March), we believe the inflation risks remain skewed to the topside simply because, for now at least, companies still possess pricing power, even in Europe. Note what Markit said on the subject in their latest Eurozone Composite PMI:

> *"The increase in raw material and energy input costs, combined with further upward pressure on wages, drove an unprecedented rise in the average prices charged for goods and services in March, with rates of inflation reaching new highs in both manufacturing and services*".

The message in their US Composite Index was similar, and our work suggests there is still a significant chunk of PPI that could be passed on to consumers. We still believe that +8% <u>core</u> PCE is possible.



Perhaps most interestingly, we also have a raft of ECB speakers and given their hawkish pivot, it will be interesting to see how they balance inflation vs events in Ukraine. As we have discussed, we believe that European fixed income remains massively mispriced and a threat to yields globally. Finally, we have an early NFP. It is always a bit of a crapshoot, but if Markit is any guide in reporting "steeper upturns in employment", it might be interesting!

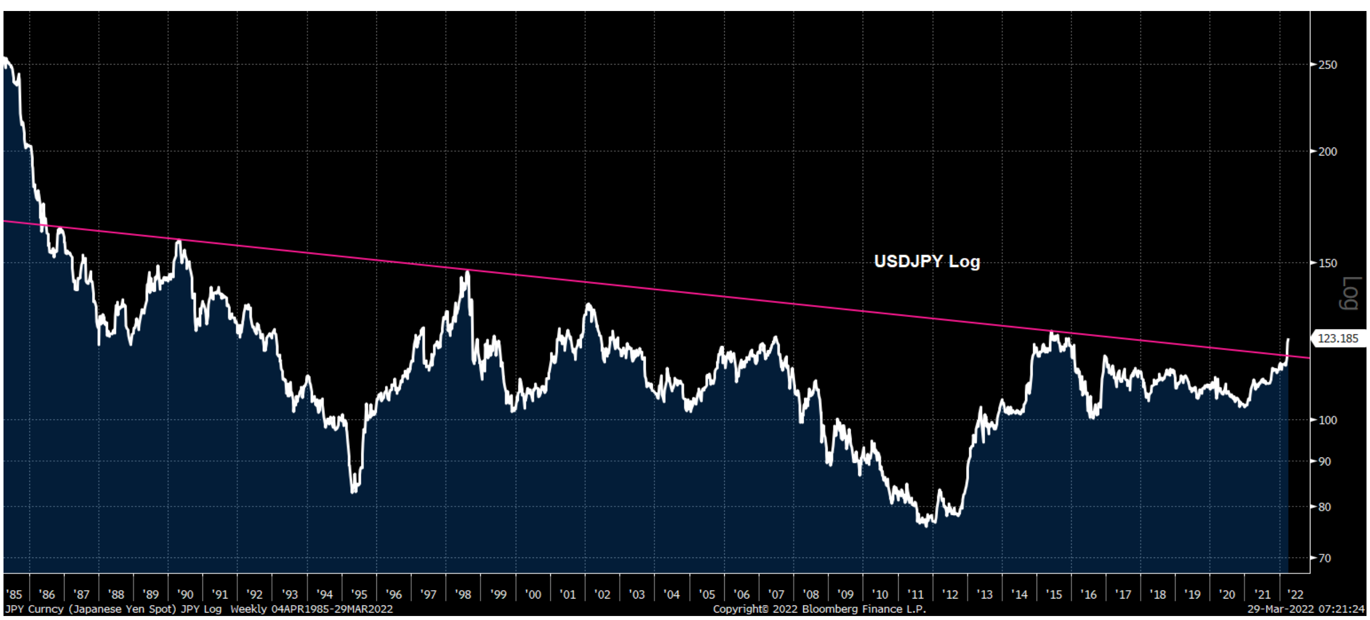
Charts

What is particularly intriguing is that we face all these potential disruptors just as the charts are getting interesting! We are sure that you've recently seen some variation of US Treasury charts with the by-line '10yrs break long term trend' blah, blah, and we aren't saying that our charts are any better. But we do feel that if you are going to use 30 or 40yr year trends, you need to use the log version. If you do, you'll see that in 2yr USTs the line on a closing basis isn't far from here, just below 2.5%.

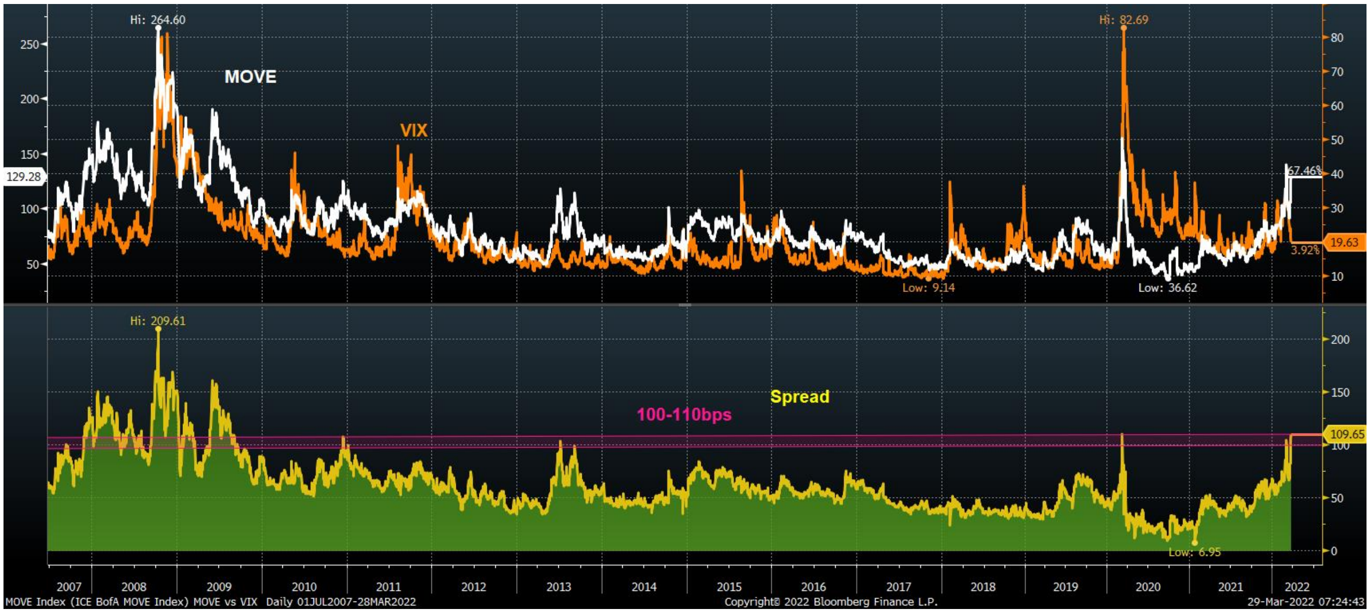
In 5yrs, which have borne the brunt of the selling, it is here at 2.60%.

While in 10s, it's still a little bit higher at 2.78%.

Interestingly, while Treasury yields have yet to break these trendlines, USDJPY, which is very rate sensitive, has blown through its 35yr trend. Is this telling us anything about bonds or just about the BoJ's obstinacy? As we have discussed, we believe that Japanese core inflation will be well above their 2% target by late summer. However, in the interim, it will be fascinating to see how Japanese investors start their new financial year in April and whether the BoJ chooses to maintain or tweak its current YCC regime (more on that separately).



Finally, one more fixed income observation. It is worth noting that the MOVE Index, a measure of bond volatility, on a spread to the VIX is at a level where it typically tops unless this is going to get a LOT worse, as it did in 2007!



That inevitably brings us to stocks, which currently seem impervious, and where investors are betting that with recession risks rising, FAANG will outperform ("MI2 Chart Point: FAANG Stocks). Unfortunately, while we see the logic, we can't help but think buyers are overlooking a few critical issues. During the pandemic, the Fed expanded the balance sheet by $4.75tln, thus providing all the fuel necessary to power the moon shot in these growth names. Yet QE just ended, and we are on the cusp of QT. The picture is utterly different! Yes, it is possible that the Fed is wrong, growth is dramatically weakening, and inflation is peaking. But is that a great picture for stocks? What's more, if growth remains solid, what equities overlook is that financial conditions still need to tighten, which requires lower stocks.

To sum up, we are at (or are approaching) some interesting technical levels in Treasuries after a very rapid and extended move. Furthermore, the level of yields combined with a weak Yen may entice Japanese buyers back into the market. Hence, while these are great levels to cover shorts, we remain hesitant to go long Treasuries just yet. Why? Part of the issue is that we would like to get through the end of the month and immediate event risk, especially in terms of inflation prints. Yes, we might miss out on the highs in yields, but we believe the market is still underestimating the risks and that many like-minded bears got squeezed in the Ukraine invasion rally, i.e. the size of the shorts are surprisingly small. Hence, we'd rather wait, because as seen in the Yen, if the trend lines break, moves can become impulsive! Finally, we really do believe that before we can get aggressively long fixed income, stocks need to buckle, and that isn't happening yet (more on that next week). Therefore, until it does, bonds still might have to do more of the tightening.