Bond markets displaying fear, equities clinging to the notion of a Fed or Trump put

Posted on May 28, 2019

The US equity market slid into the close on Tuesday to sit on key supports. The market is beginning to acknowledge that trade policy actions to date are significant impediments to US, China and global growth and earnings. The bond market has proven more responsive to risks to growth so far this year. Bond yields have fallen to a low since 2017, the US yield curve remains inverted this year, inflation expectations have fallen to new lows in Europe and Australia, and have fallen in recent weeks in the USA. Real yields have fallen to new lows in Australia and the UK. Bond volatility has lifted relatively more than equity vol; FX vol remains tepid. The market is pricing in significant rate cuts by the US Fed. Equity investors are clinging to the notion of a Fed or Trump put.

No Thaw in year-long escalation

Coming out of the US long weekend, with little new news on US-China trade relations, asset markets are displaying increased concern that trade relations will drag down global growth.

Trump threw the market a bone late last week, suggesting that the Huawei ban could be just a bargaining chip in trade negotiations. However, the market is wary of reading too much into these kinds of throwaway lines.

The deterioration in trade and economic relations has been escalating for over a year since the US first raised tariffs on solar panels and washing machines in March 2018. The market may be starting to pay more attention to actions rather than words. Policy hawks in the US administration have consistently gained the upper hand.

The market is still hoping that a possible meeting between Xi and Trump on the sidelines of the 28/29 G20 summit will reset the trade talks.

It is possible that talks restart and concessions are eventually made. However, the longer the two sides remain apart, the more it seems that their longer-term strategic goals will prevent trade harmony. The Huawei ban suggests the strategic race for market share in high tech industries will continue to fuel tensions between the two superpowers.

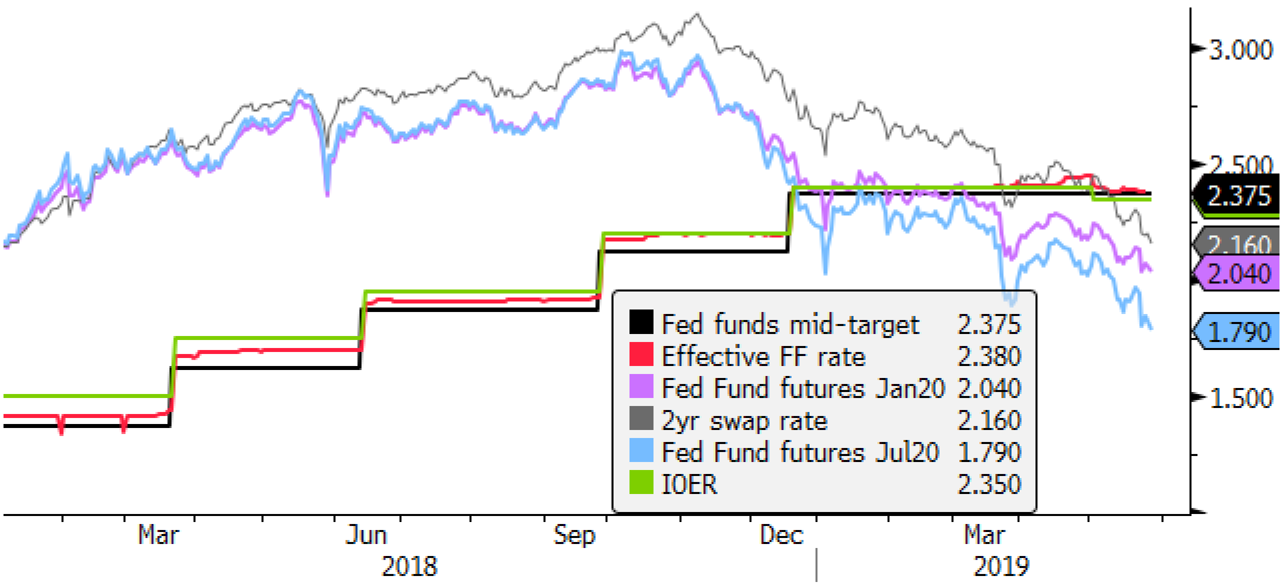
We must also remain vigilant for further escalation. The US administration has said that it is prepared to extend 25% tariffs from around half of Chinese imports to all imports. And China can retaliate against US companies doing business in China.

Bonds markets displaying more concern for global growth

The biggest macro impact so far appears to be coming through the bond market. US equities have followed, but bond yields have fallen further and more decisively and appear to be signalling greater risk of weaker global economic growth than equity markets at this stage.

Equity investors may be taking some confidence from falling bond yields, seeing lower yields as a sign that central banks will ease policy to help underpin economic growth. The market is pricing the Fed funds rate 34bp lower by year end and 59bp lower by mid next year; despite Fed members suggesting that they have no clear bias to move rates.

US rate expectations – Fund funds priced to be 34bp lower by year end and 59bp lower by mid-2020



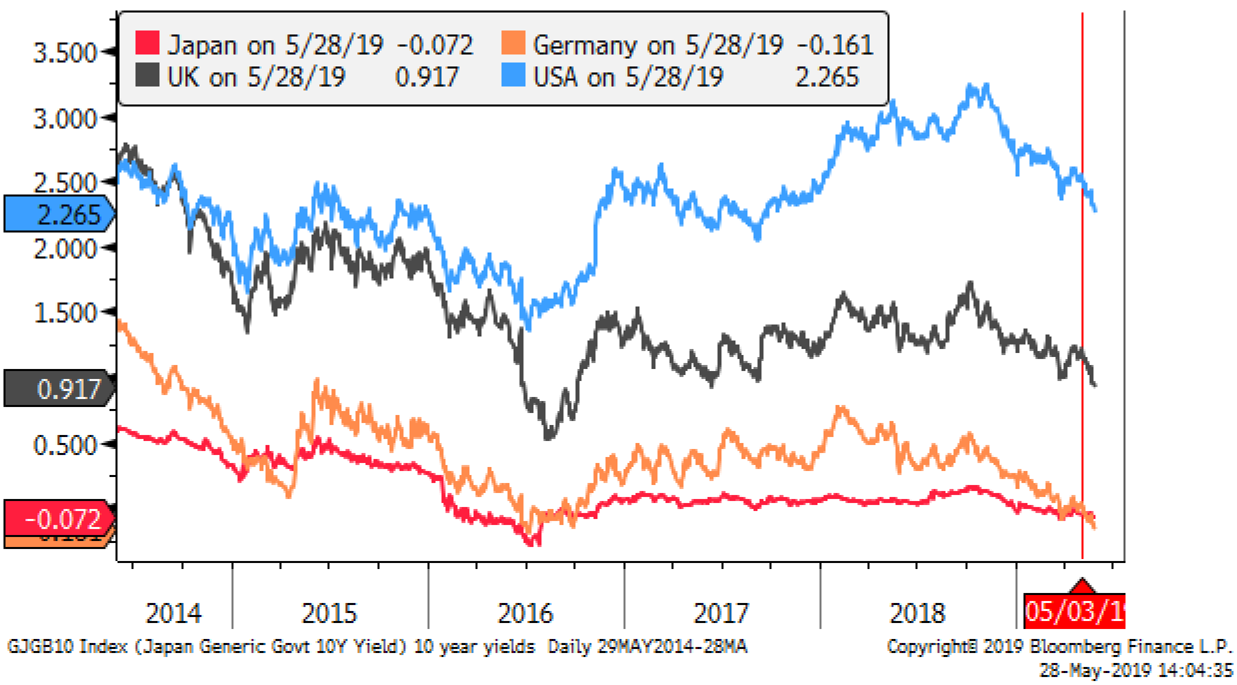
FDTRMID Index (Federal Funds Target Rate Mid Point of Range) US rate exp Daily Copyright© 2019 Bloomberg Finance L.P. 28-May-2019 13:24:09

Lower bond yields do lower the valuation hurdle for equities, but they also show increased concern that economic growth and company earnings will fall.

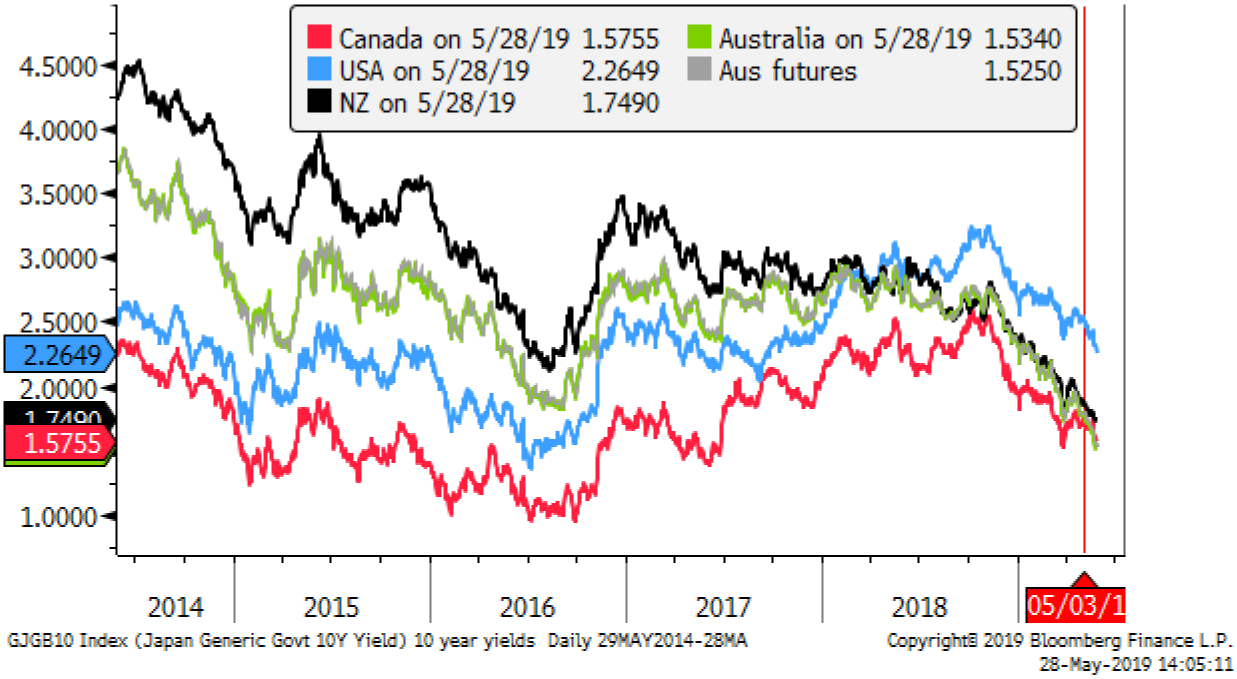
Interestingly, the recent correction in equities has been matched by renewed falls in yields to lows since 2017. In contrast, the corrections in equities in February and Q4 last year (that are still more significant at this stage) were driven by rising yields, tightening monetary conditions.

The recent fall in equities has been led by lower bond yields, in contrast to corrections in equity markets last year that followed rising yields, and tightening global monetary conditions

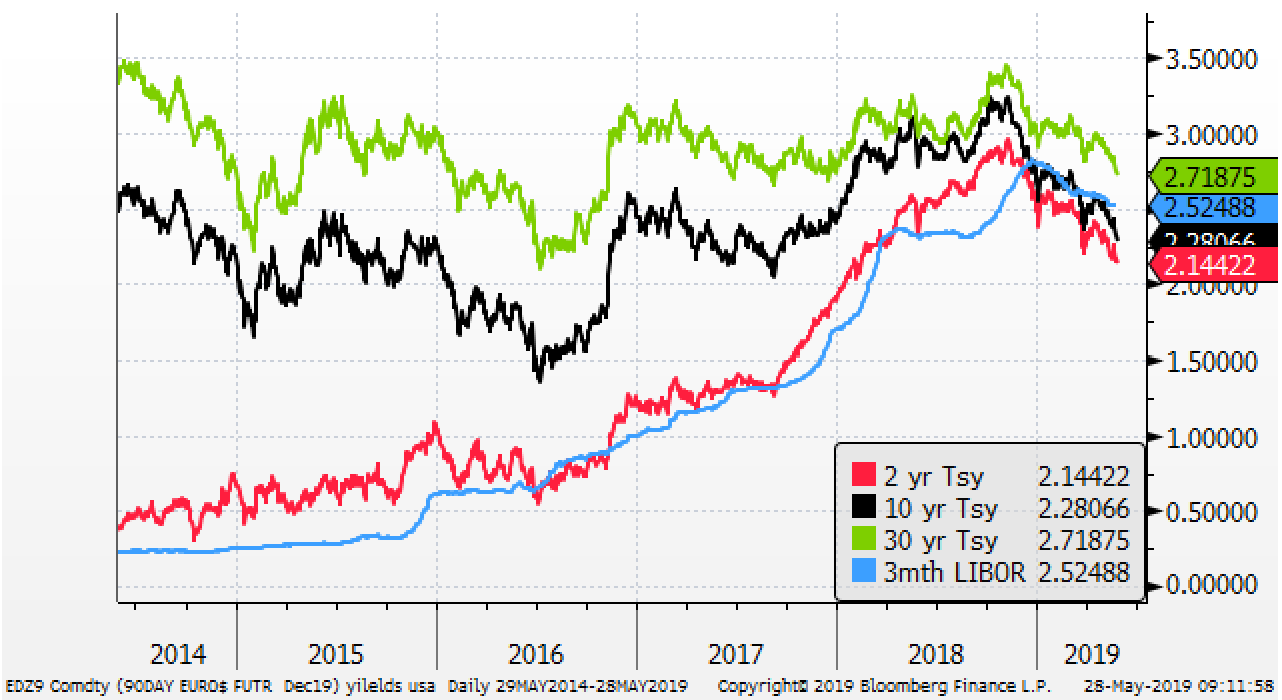
US 10-year yields at a low since Sep-2017. German 10-year yields significantly negative, and below Japanese yields. German and UK yields at a low since 2016 (approaching record lows).



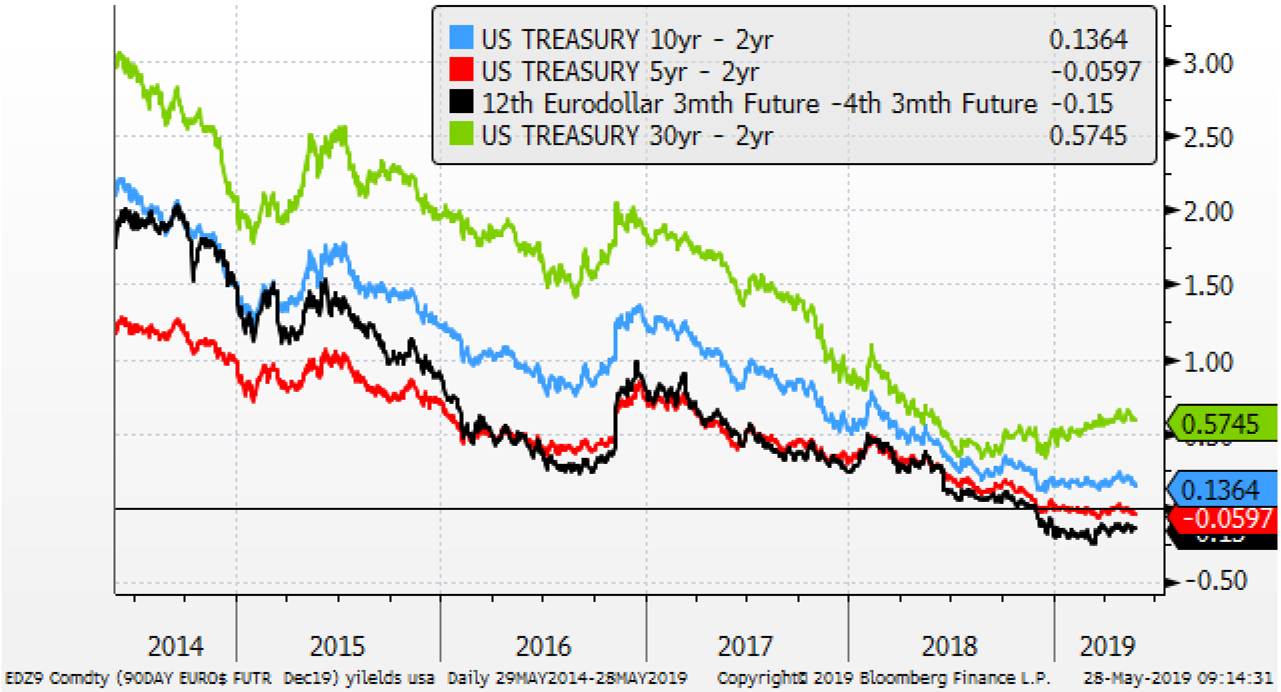
Australian and New Zealand yields at record lows, falling significantly below US yields since early-2018



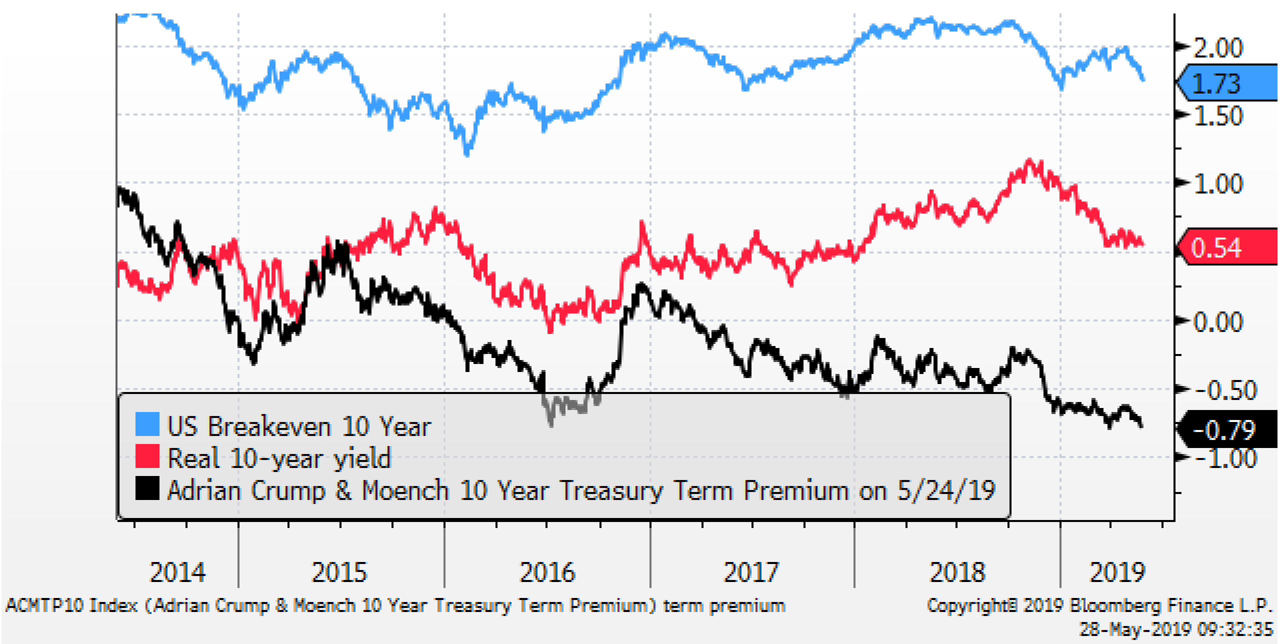
US yields across the curve – inversion as 10-year yields move below 3mth yields by 20bp, equal to the previous peaks in inversion in Jan and March



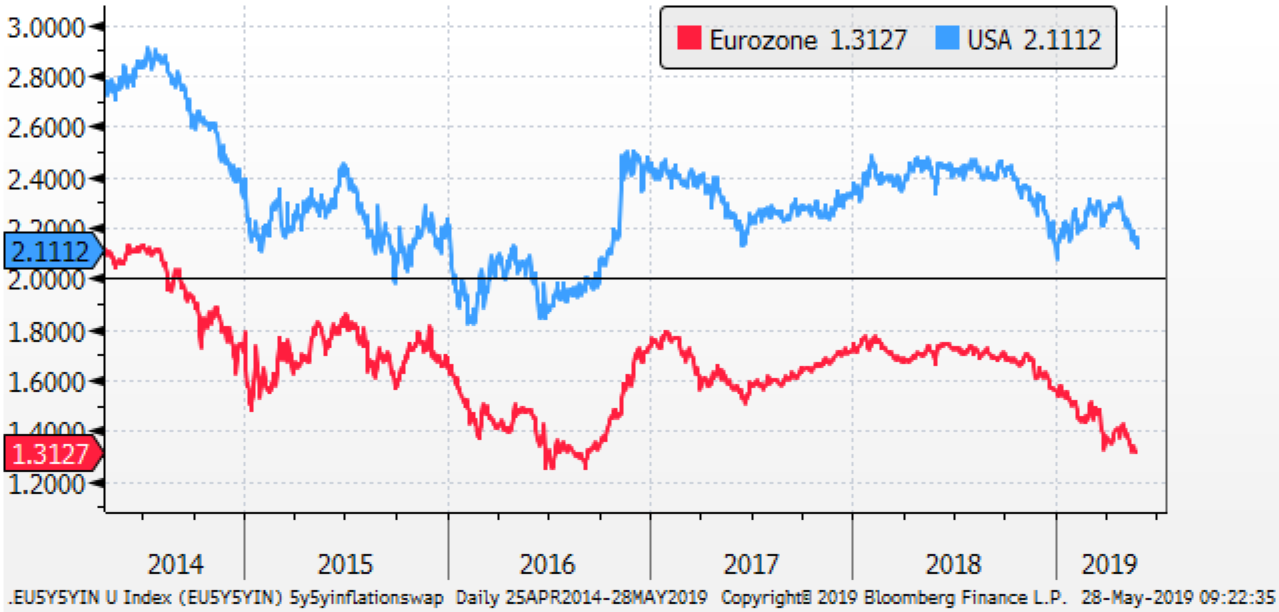
US yield curve shape – little change since December with modest inversion at the front on the curve (out to 5yrs). Some steepening between 10 and 30 years, pointing to long term rising risk in US government debt



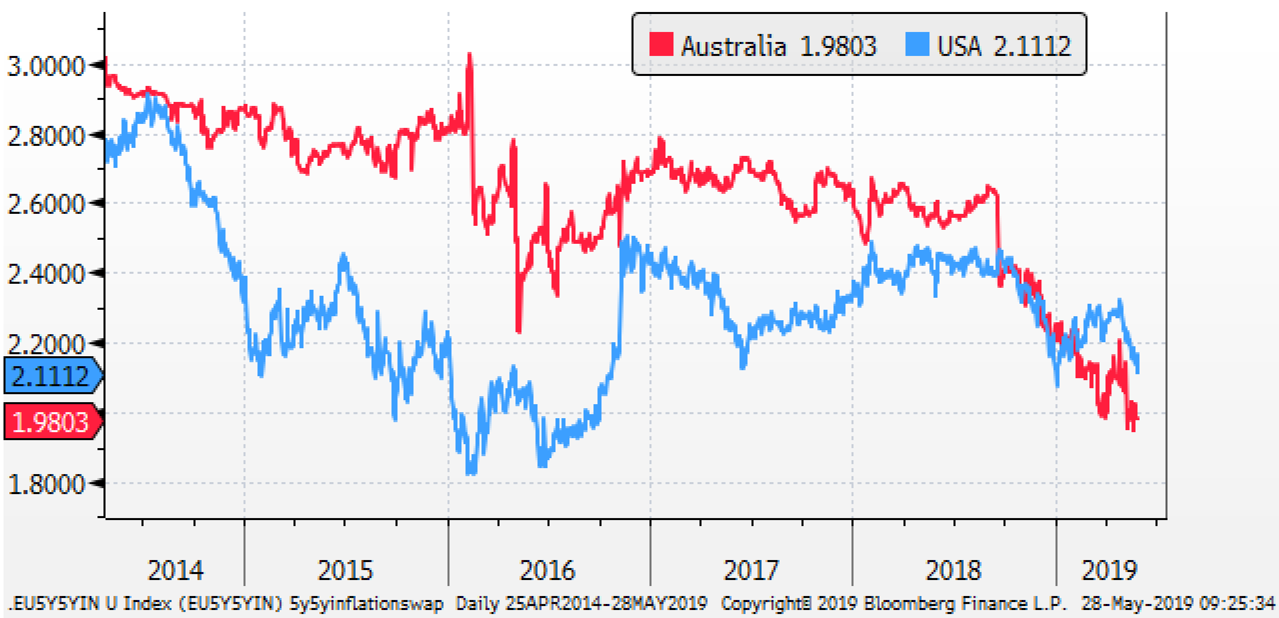
The recent fall in US yields since early May, as trade tensions escalated, has been mainly reflected in lower inflation compensation. US real yields have been relatively stable since March; albeit at around the lows in over a year. The ACM estimate of the 10-year term premium is around record lows, significantly negative, despite Fed QT.



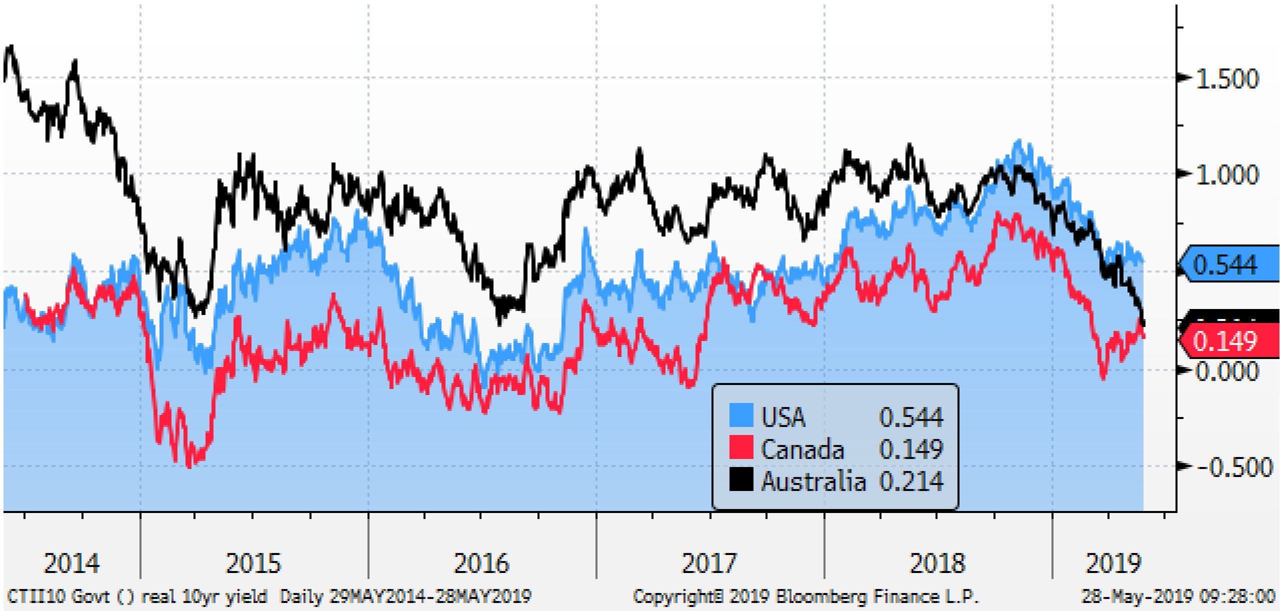
5-yr-5-yr forward inflation swaps - Since 25-April, US long-term inflation compensation has been falling. Eurozone inflation compensation has fallen to a new low since 2016



Australian long term inflation expectations are at a record low

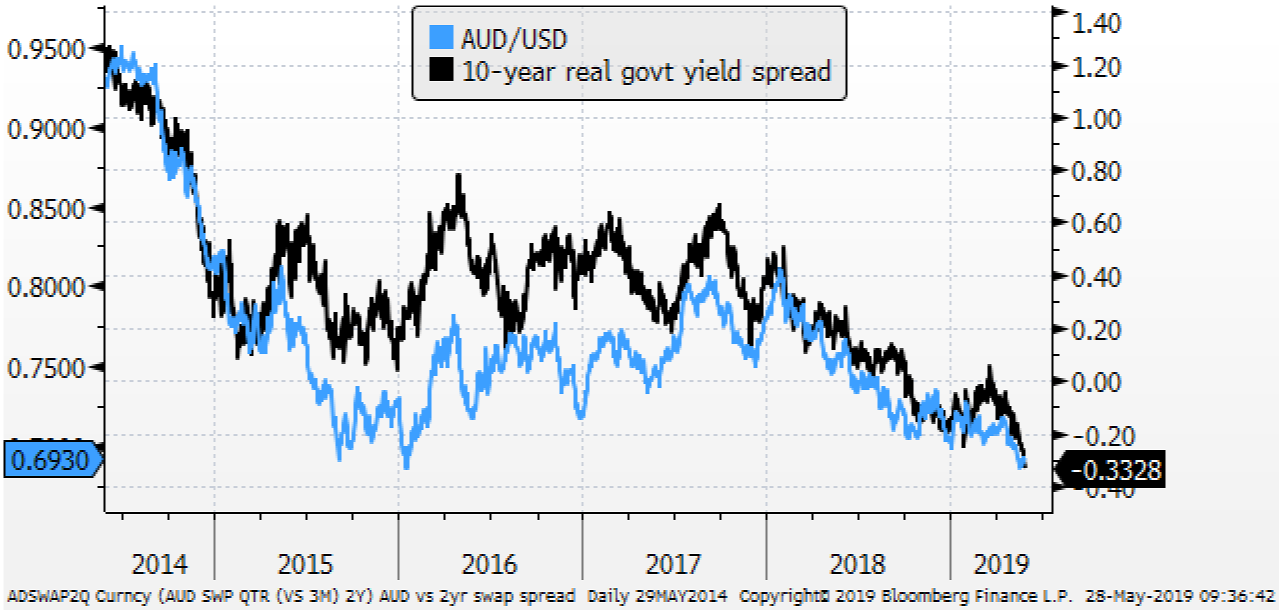


Real 10-year yields – stable in the USA since late-March, firmer in Canada, lower in Australia to record lows.



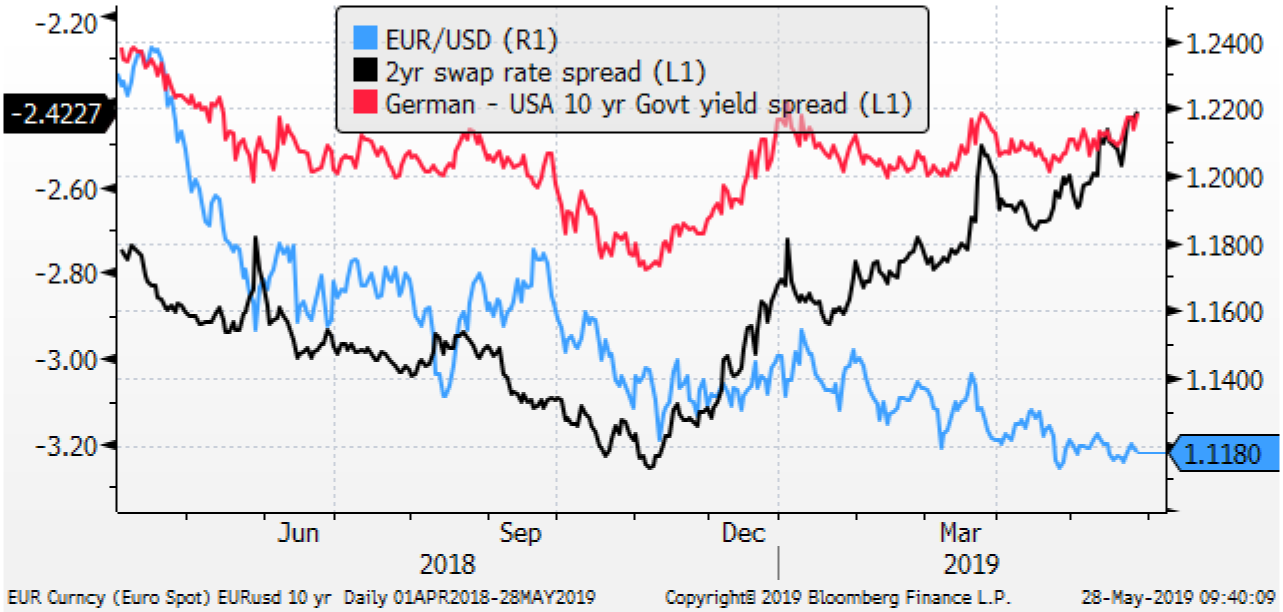
UK real yields significantly negative at record lows

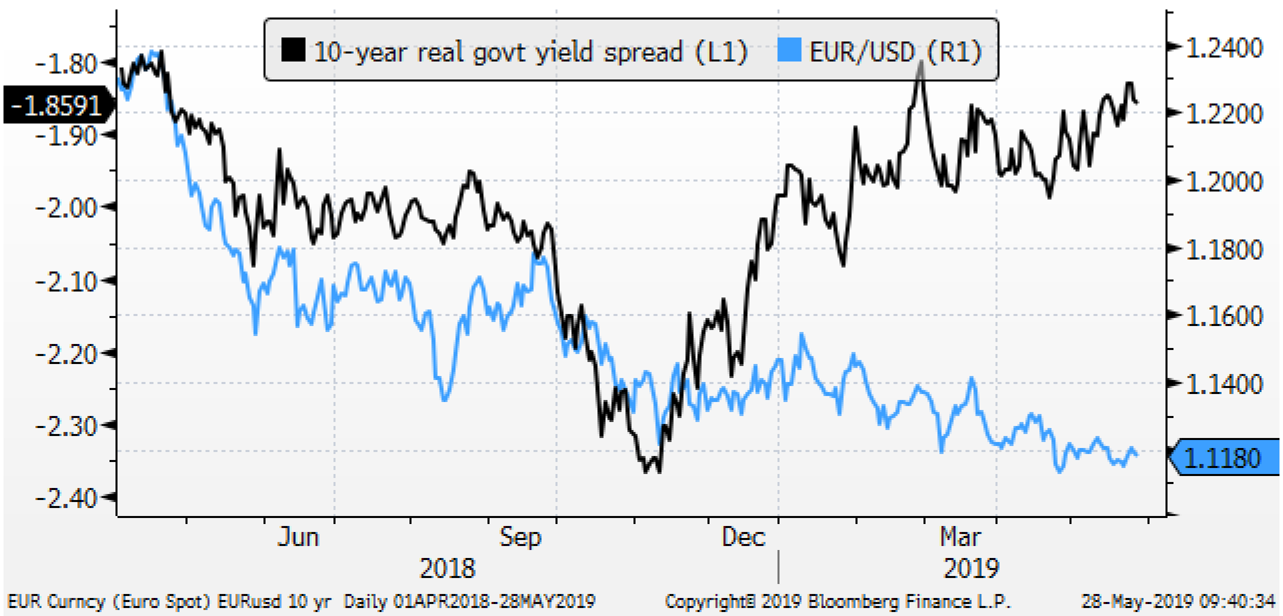
The real 10-year yield spread may help explain the weaker AUD/USD



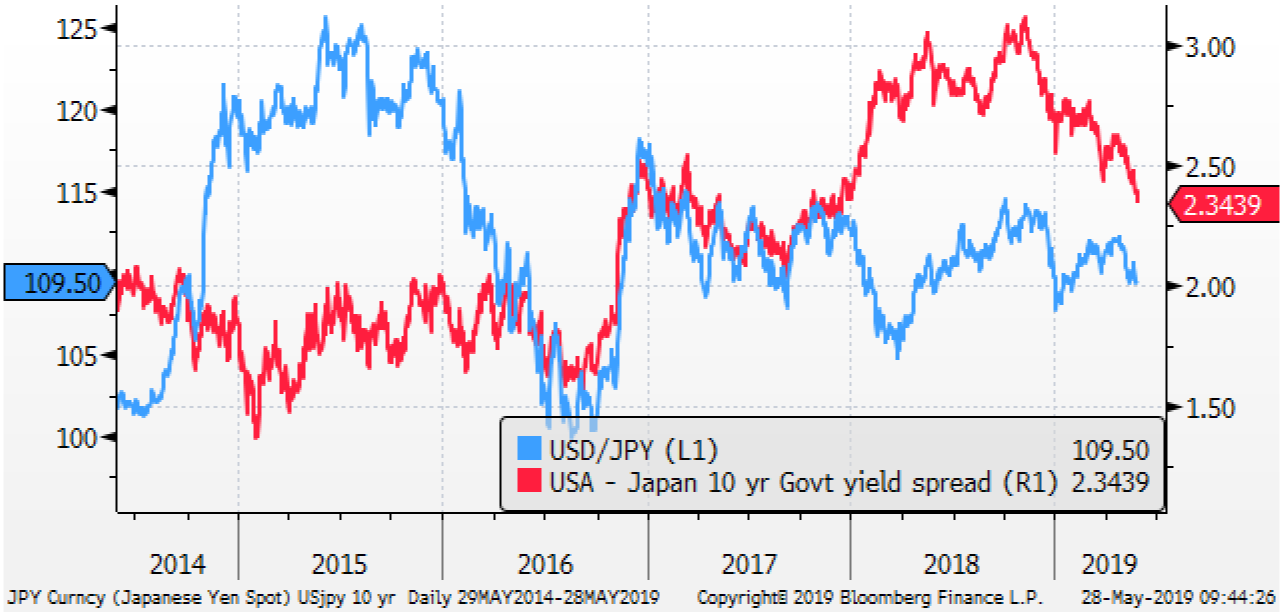
Similarly, the slide in UK real yields is consistent with a weaker GBP. Both are indicative of Brexit risks

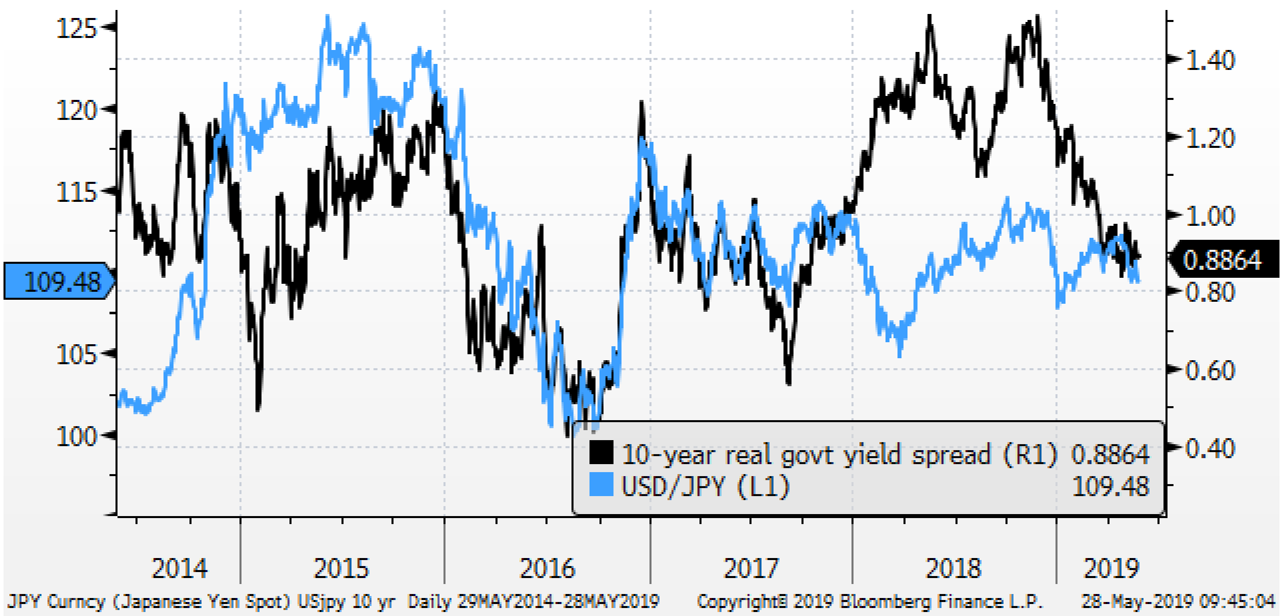
The ongoing slide in the EUR this year is not consistent with rising nominal and real yield spreads (diminishing yield disadvantage)



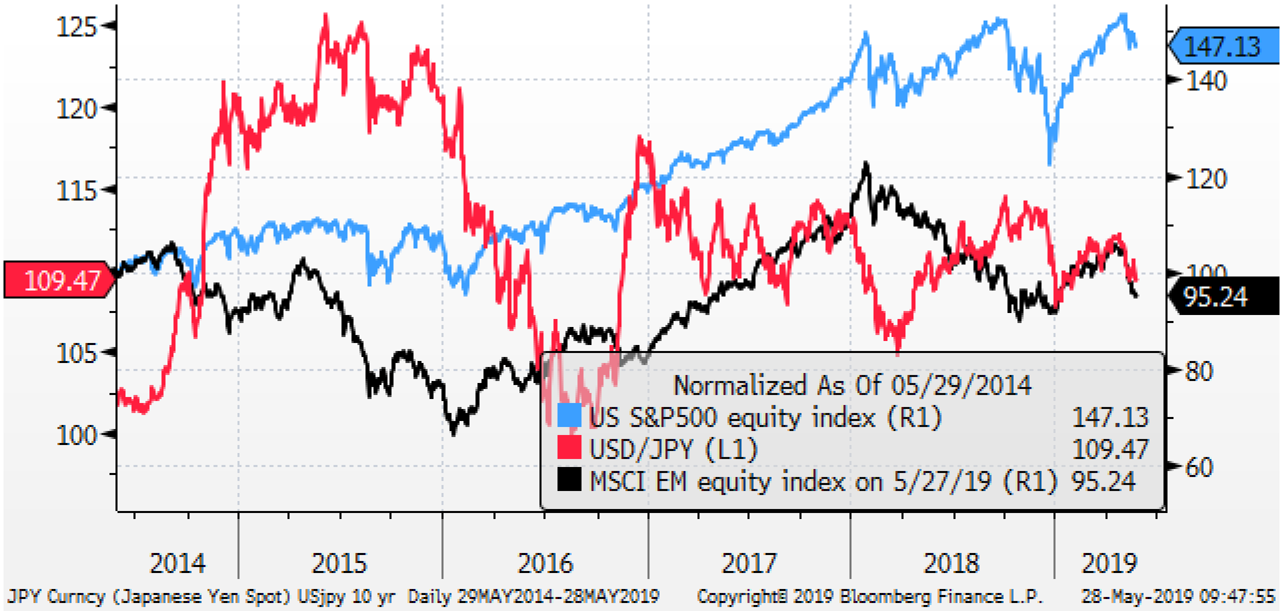


Recent strength in JPY is consistent with weaker US nominal yields, although the relationship between JPY and yields is much weaker than in 2016/2017

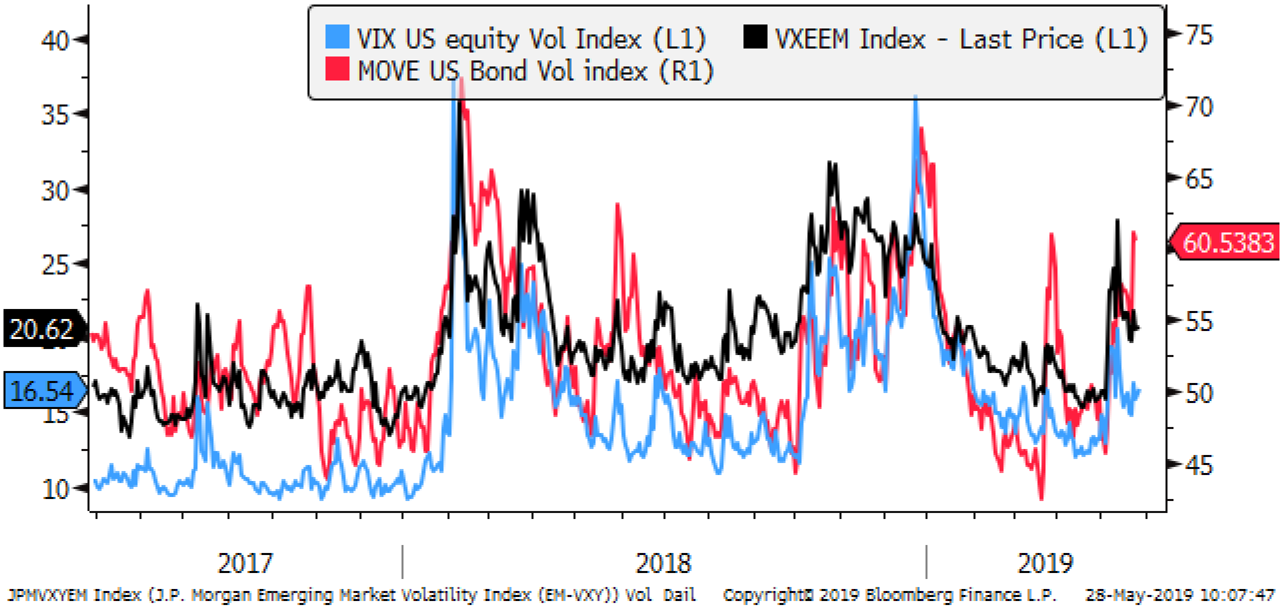




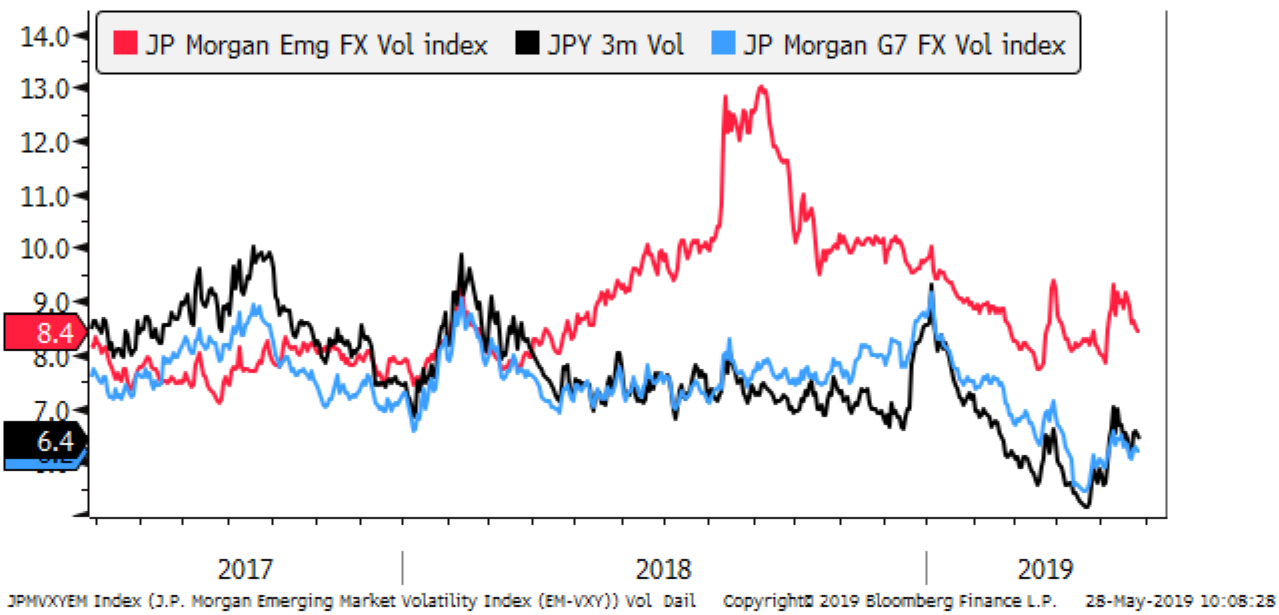
USD/JPY has been more consistent with equities this year



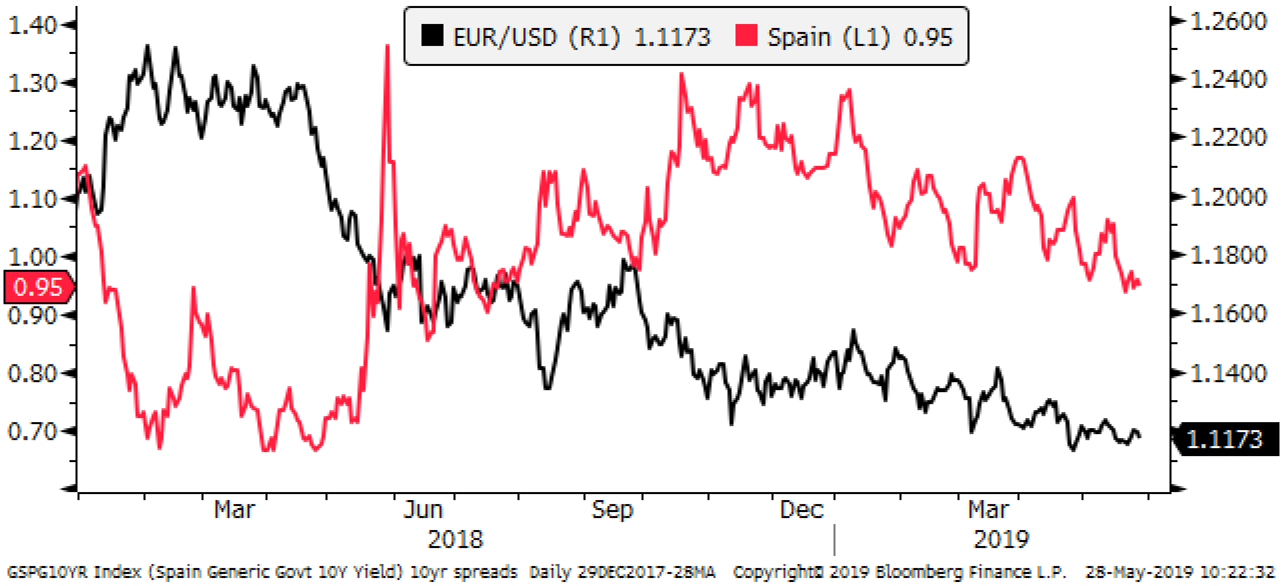
Asset implied volatility levels have risen modestly in the last month; bond vol has risen more significantly

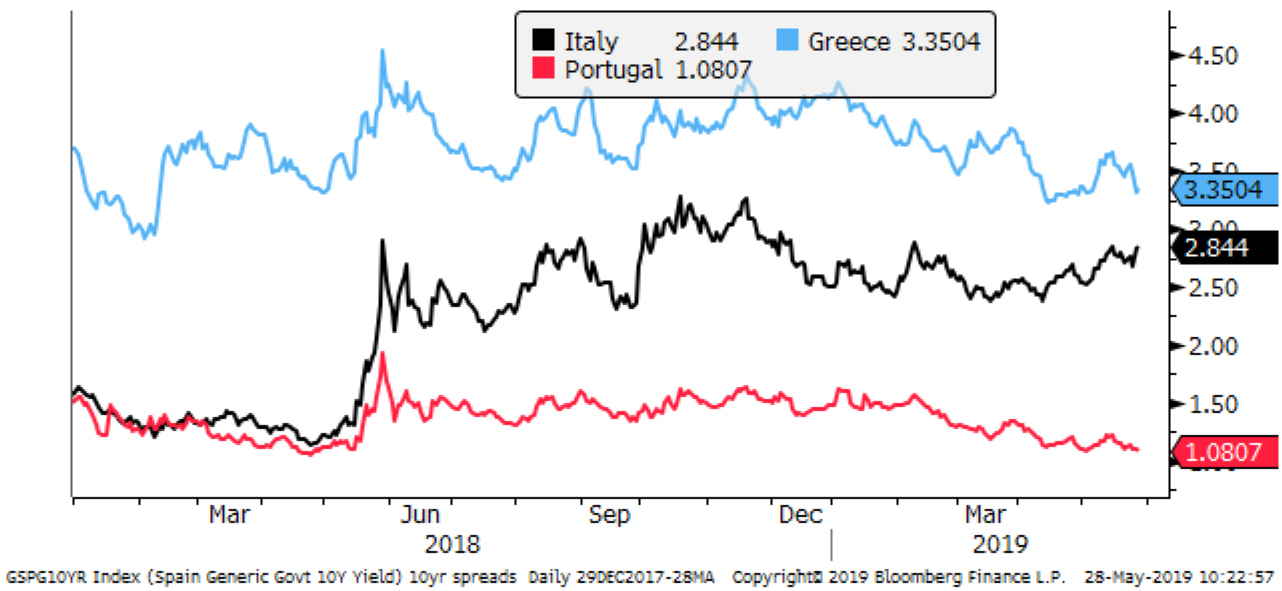


FX vol has lifted only modestly from low levels

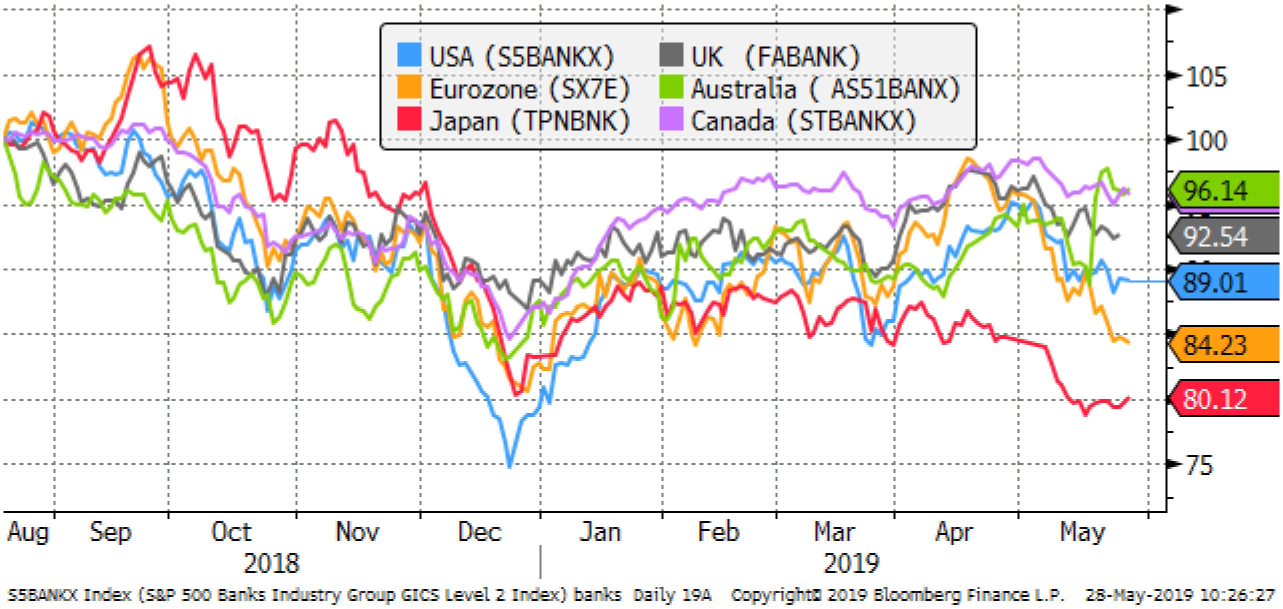


10 year sovereign spreads - Italian bond yield spreads over German bunds have risen on increasing tensions over Italy's budget expected in coming months. However, Spanish, Portuguese and Greek spreads have been narrowing

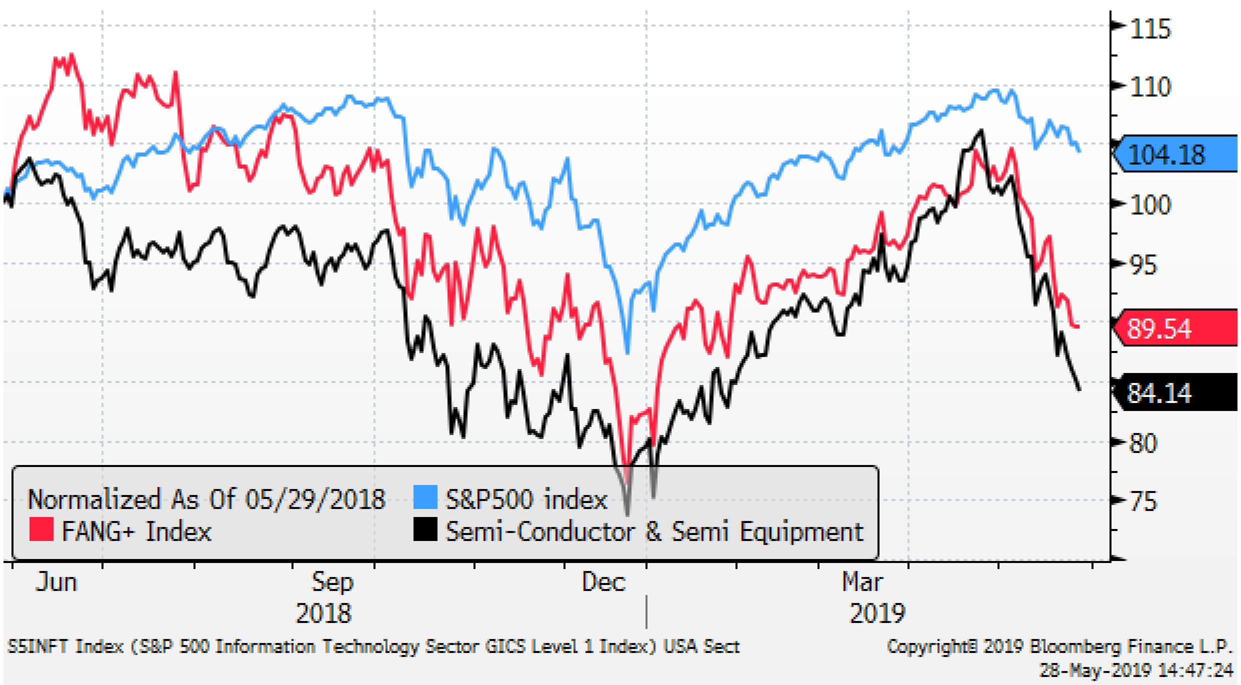




However, Eurozone bank share prices have fallen more than peers in recent weeks



Some of the biggest US equity falls include the semiconductor sector and large-cap growth high tech companies in the US and China. These companies have the most to lose from a trade war



Towards the close in the US equity market, there was broad-based selling that appeared to reflect a more genuine risk-off mood. Broad US equity indices are sitting close to supports that may point to increased risk of a significant further near term fall.

S&P500 index

Russell 2000 small caps

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