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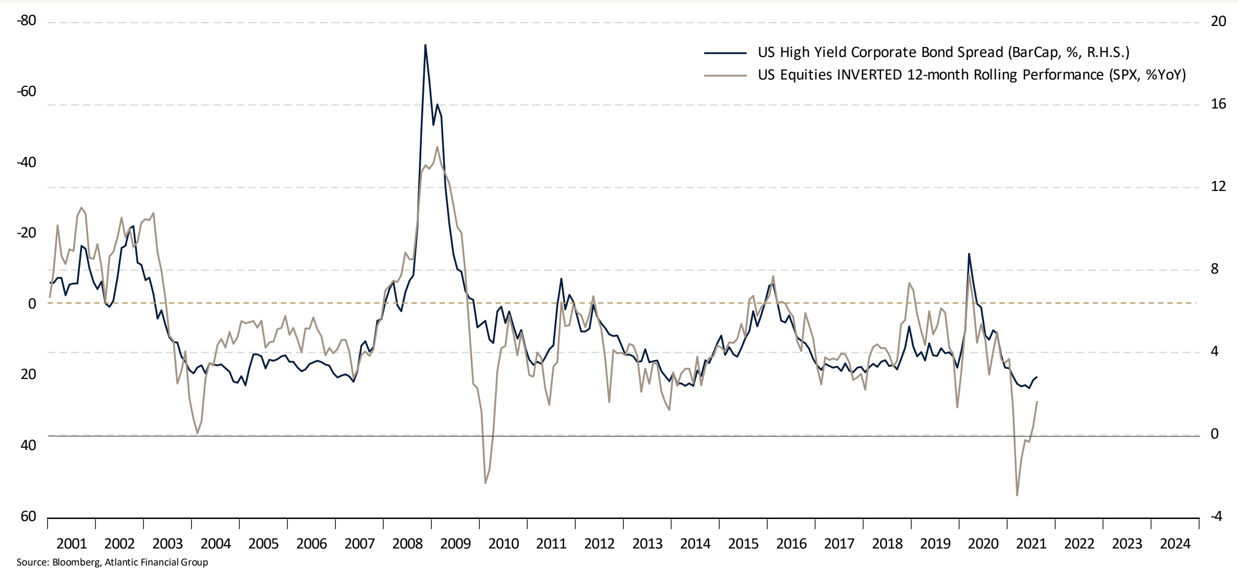
Weekly Investment Focus

23 August 2021

"LISTENING TO THE BOND MARKET"

- US 10-year yields have been falling for several months
- This signal of a loss of economic momentum can be seen in all markets, even stock markets
- Falling bond yields are also a consequence of Fed intervention
- Beware of the *high yield* segment, as credit risk is no longer remunerated

CHART OF THE WEEK: "High yield bonds and equities: what's the difference?"



Source: Bloomberg, Atlantic Financial Group

BOND MARKET ANALYSIS

After a complicated first quarter, during which they promptly rose from 0.90% to 1.77%, **US 10-year bond yields have been falling steadily.** They are now oscillating around 1.25%. This downward trend has not been accompanied by an equivalent movement on the short end of the yield curve. In June, when the Federal Reserve (Fed) announced a hypothetical tightening of monetary policy in 2023, 2-year yields had not really moved up, so they can't fall today, and the US yield curve is naturally flattening (see Fig. 2). The spread between 10- and 2-year rates has dropped from 158 to 103 basis points over the last 5 months.

Fig. 2 – US bond yield spread

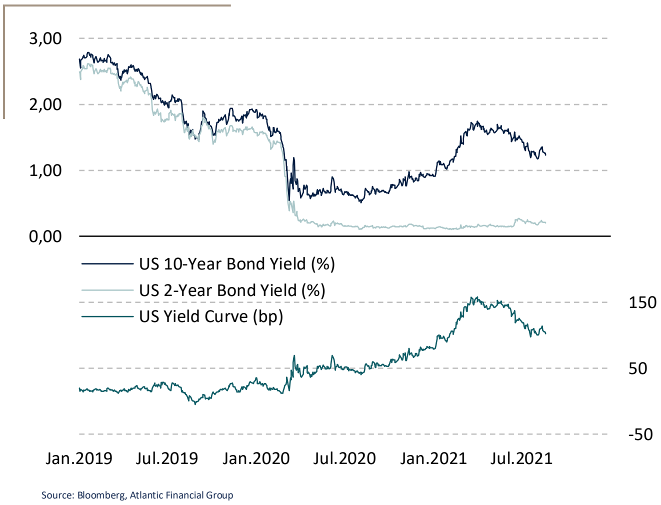
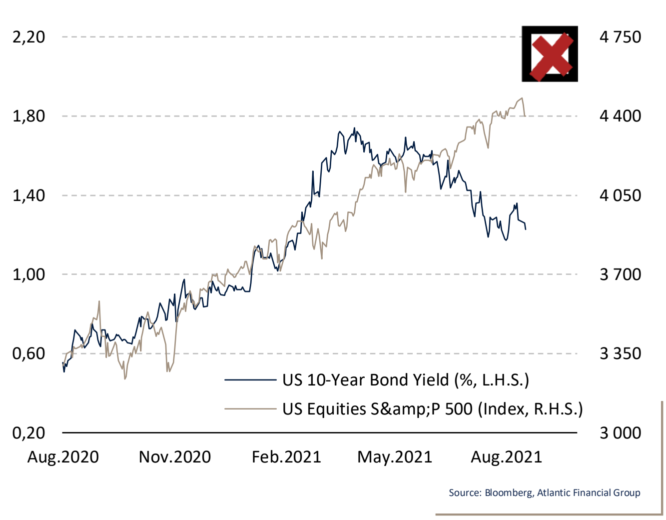


Fig. 3 – US bonds vs. equities



This move may seem anachronistic in view of the optimism relayed by the stock markets (see Fig. 3). Usually, when long rates fall, this signal of economic slowdown prompts equity investors to reduce their exposure and the stock market to fall. This was not the case recently.

Fig. 4 – US bonds vs. oil prices

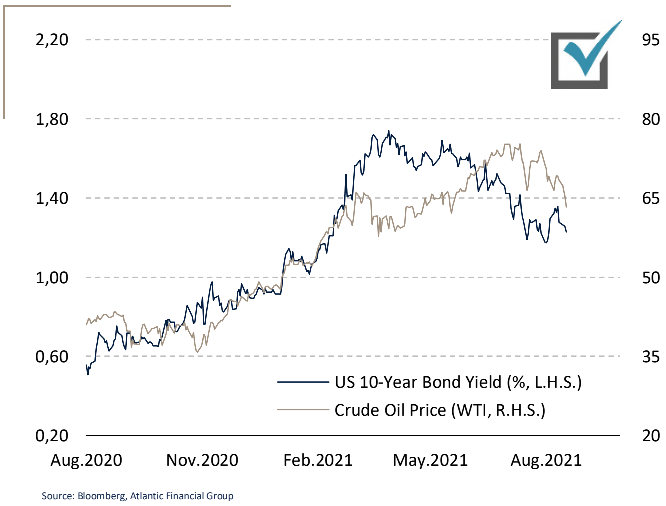
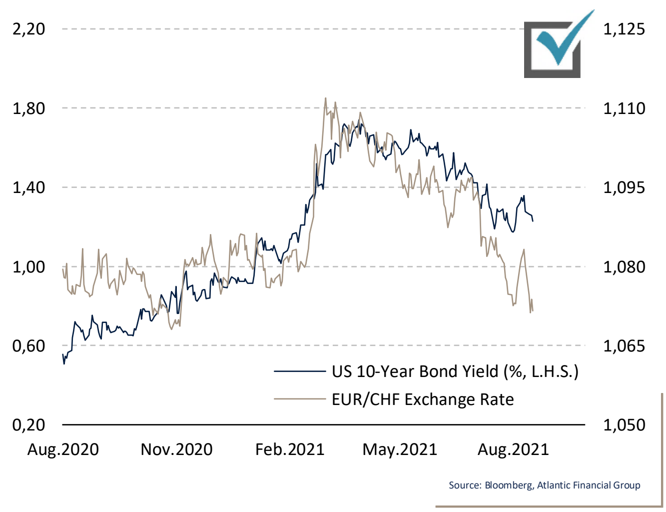


Fig. 5 – US bonds vs. EUR/CHF exchange rate



In the very short term, however, there are strong signals to justify the recent downward movement in bond yields. It is anything but an isolated event:

- After peaking at the beginning of July, **the price of US crude oil** (WTI) has fallen steadily from USD 75 to USD 67 **per barrel** (see Fig. 4).
- **Leading economic indicators,** such as those measuring purchasing managers' confidence in industry (PMI), reached their highest levels ever in June and have since been trying to avoid a sharp fall (see WIF of 2 August 2021).

- In the forex market, **the Swiss franc** is taking advantage of its safe haven status to appreciate against all its major counterparts, including the euro (see Fig. 5).
- Even in the stock market, looking at the details, investors are not as cheerful as they appear. **The outperformance of defensive sectors** (see Fig. 6), large caps (see Fig. 7) and Swiss equities sends a message of caution.

Fig. 6 – US bonds vs. cyclical/defensive stocks

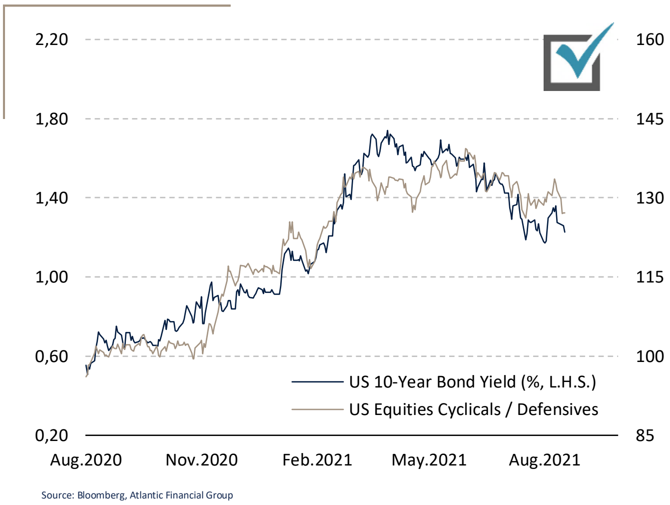
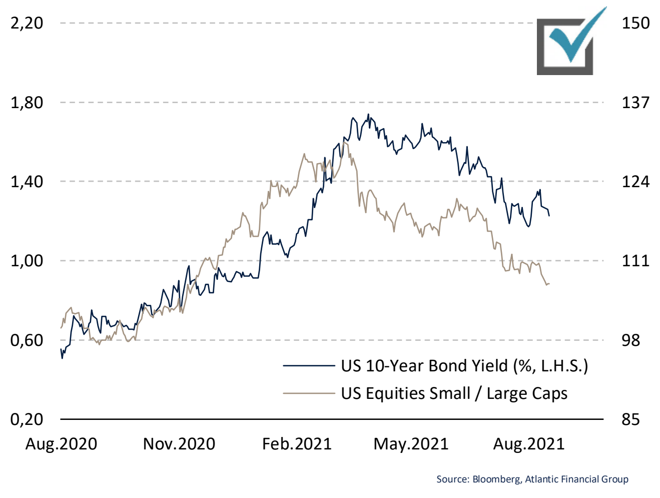


Fig. 7 – US bonds vs. small/large cap stocks

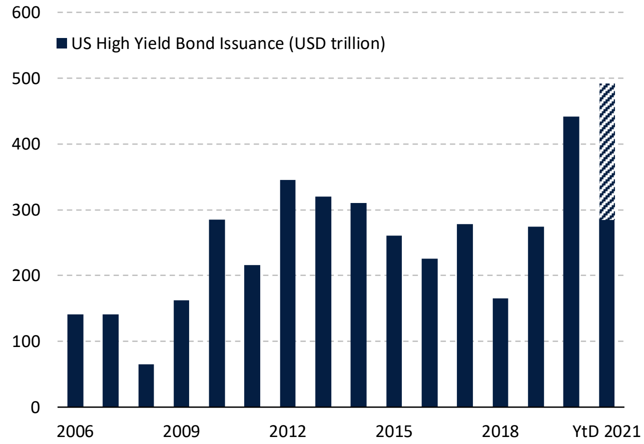


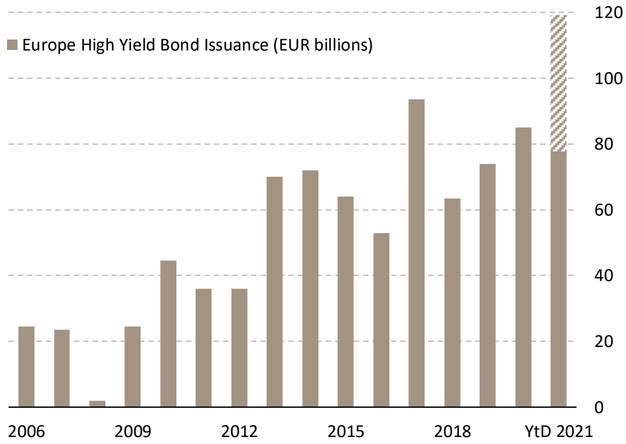
In the longer term, as we recently detailed (see WIF of 28 June 2021), **the US central bank has no choice but to prevent rates from rising too fast and too high.** Otherwise, government, corporate and household debt would become unsustainable. This reasoning by absurdity does not guarantee the effectiveness of monetary policy, as it is possible that the Fed will not succeed in preventing a rise in bond yields. However, one thing is certain: the central bank will do everything in its power to do so.

In his latest monetary policy statement, the Fed Chairman said that the support to the economy could be tapered as early as the end of this year. Such an announcement should have pushed up 10-year yields. However, they have continued to fall. Bond investors believe that either the Fed governors will reconsider and not reduce the pace of their asset purchases (120 billion per month), or that they will do so and economic conditions will deteriorate rapidly. Jerome Powell will give details on this hot topic in his next speech, during the global meeting of central bankers in Jackson Hole on 26 and 27 August and at the next Fed meeting on 21 and 22 September.

With sovereign rates back to very low levels, investors are desperately looking for yield. As a result, they are overly focused on high-yield. Within the bond market, this segment is becoming a concern. It consists of low-quality corporate bonds with very, or even too, high debt ratios. Typically, these companies struggle to issue new debt and offer high yields to attract investors. In 2021, in an unusual way, issuance is reaching record highs (see Figs. 8 & 9) even as spreads hit rarely seen low levels. Obviously, **credit risk is no longer rewarded and the probability of a spread widening becomes likely.**

Fig. 8 & 9 – Bond issuance in the US and Europe





Source: S&P LCD, Atlantic Financial Group

This is especially important as high yield bonds probably have the most confused identity in portfolios. Of course, they are bonds, but their correlation with the equity market (see Chart of the Week) is much stronger than with the sovereign debt market. Investors who have sought to switch from long-dated sovereign bonds to short-dated high-yield bonds, in search for yield, will be left out in the cold. They will not be as well protected as they would like to be during periods of market correction. This type of bond reallocation, if excessive, constitutes a strategic risk.

Conclusion:

The fall in bond yields may seem incomprehensible to equity investors, but economic indicators and the various financial markets justify this movement. Moreover, the Fed has no option but to keep rates low enough to make debt sustainable, whether public or private. The tightening of monetary policy (tapering) expected by the consensus looks like wishful thinking. In the corporate bond market, high yield will suffer at the same time as equities drop. Although they no longer provide a decent return, they do not protect portfolios during risk-off periods. It is better to temporarily skip them.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2021 Year-to-Date (%)	2020 (%)	2019 (%)
Equities							
World (MSCI)	719.9	40.81	-2.0%	1.9%	12.8%	16.9%	27.3%
USA (S&P 500)	4 416	50.69	-1.2%	3.6%	18.4%	18.4%	31.5%
USA (Dow Jones)	34 999	46.97	-1.6%	2.9%	15.3%	9.7%	25.3%
USA (Nasdaq)	14 644	43.26	-1.8%	2.0%	13.3%	45.1%	36.7%
Euro Area (DJ EuroStoxx)	464.8	50.83	-1.9%	5.6%	19.1%	0.8%	27.3%
UK (FTSE 100)	7 071	45.11	-1.6%	3.9%	12.2%	-11.4%	17.2%
Switzerland (SMI)	12 396	61.43	-0.2%	4.6%	19.1%	4.3%	30.2%
Japan (Nikkei)	27 013	35.54	-2.6%	-1.3%	0.2%	18.3%	20.7%
Emerging (MSCI)	1 232	29.20	-4.5%	-6.2%	-3.1%	18.8%	18.8%
Brasil (IBOVESPA)	116 164	31.12	-2.9%	-5.8%	-1.6%	2.9%	31.6%
Russia (MOEX)	3 837	52.26	-0.9%	4.3%	21.9%	14.8%	38.4%
India (SENSEX)	55 329	68.57	2.0%	4.8%	17.4%	17.2%	15.7%
China (CSI)	4 769	35.94	-2.2%	-4.7%	-5.3%	29.9%	39.2%
Communication Serv. (MSCI Worl	113.54	37.92	-2.1%	0.3%	13.6%	24.2%	25.1%
Consumer Discret. (MSCI World)	383.7	27.84	-5.1%	-3.5%	1.7%	37.0%	28.2%
Consumer Staples (MSCI World)	280.2	52.19	0.2%	1.0%	6.4%	8.8%	22.4%
Energy (MSCI World)	162.3	30.49	-6.4%	-0.6%	16.1%	-27.7%	13.9%
Financials (MSCI World)	145.7	47.33	-2.8%	5.3%	20.1%	-3.1%	24.1%
Health Care (MSCI World)	365.0	64.70	1.5%	4.8%	16.0%	15.4%	23.3%
Industrials (MSCI World)	323.0	41.06	-2.6%	2.0%	12.8%	11.8%	27.2%
Info. Tech. (MSCI World)	520.5	48.11	-1.1%	2.8%	15.3%	46.2%	47.5%
Materials (MSCI World)	358.4	33.56	-4.9%	0.8%	11.6%	21.6%	20.8%
Real Estate (MSCI World)	225.5	47.96	-0.2%	0.7%	17.4%	-5.7%	24.0%
Utilities (MSCI World)	158.6	68.26	1.2%	5.0%	7.2%	4.8%	22.3%
Bonds (FTSE)							
USA (7-10 Yr)	1.25%	56.64	1.1%	-0.2%	-1.2%	9.3%	7.4%
Euro Area (7-10 Yr)	-0.16%	67.33	0.1%	0.8%	-0.1%	4.5%	6.7%
Germany (7-10 Yr)	-0.49%	70.39	0.3%	0.8%	-0.6%	3.0%	3.0%
UK (7-10 Yr)	0.53%	59.63	0.5%	0.1%	-2.4%	5.4%	4.8%
Switzerland (7-10 Yr)	-0.39%	62.51	0.0%	0.2%	0.0%	0.4%	2.0%
Japan (5-10 Yr)	0.01%	56.24	0.1%	0.0%	0.4%	-0.1%	0.0%
Emerging (5-10 Yr)	4.36%	59.17	0.2%	0.1%	-0.7%	5.2%	13.3%
USA (IG Corp.)	2.00%	55.08	0.2%	-0.1%	-0.2%	9.9%	14.5%
Euro Area (IG Corp.)	0.17%	67.77	0.1%	0.3%	0.8%	2.8%	6.2%
Emerging (IG Corp.)	4.21%	51.02	0.0%	-0.4%	0.5%	8.1%	13.1%
USA (HY Corp.)	4.19%	41.14	-0.1%	0.0%	3.5%	7.1%	14.3%
Euro Area (HY Corp.)	2.90%	71.03	0.0%	0.6%	3.7%	2.3%	11.3%
Emerging (HY Corp.)	6.52%	41.70	-0.3%	-0.4%	0.3%	4.3%	11.5%
World (Convertibles)	439.5	32.69	-2.1%	0.3%	2.7%	38.8%	17.3%
USA (Convertibles)	593.0	34.51	-2.3%	0.5%	3.1%	54.5%	22.8%
Euro Area (Convertibles)	4 176	45.84	-0.4%	1.1%	1.5%	6.1%	7.6%
Switzerland (Convertibles)	187.9	73.13	0.1%	0.2%	0.6%	0.5%	2.4%
Japan (Convertibles)	196.1	35.92	-1.0%	-0.7%	0.9%	2.8%	2.6%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	713.5	64.71	n.a.	0.3%	6.3%	2.5%	9.3%
Distressed	940.9	73.67	n.a.	-0.9%	9.5%	1.5%	1.4%
Event Driven	788.2	75.34	n.a.	-0.5%	9.6%	3.1%	8.2%
Fixed Income	390.5	77.63	n.a.	0.6%	4.4%	2.2%	6.1%
Global Macro	1 168.6	71.06	n.a.	0.1%	6.3%	2.0%	10.4%
Long/Short	914.4	71.84	n.a.	1.4%	6.8%	3.6%	12.2%
CTA's	338.4	67.49	n.a.	0.9%	7.2%	-3.2%	9.0%
Market Neutral	285.8	37.91	n.a.	1.5%	4.6%	-0.1%	1.6%
Multi-Strategy	687.6	76.02	n.a.	1.1%	5.5%	1.4%	7.3%
Volatility							
VIX	20.61	64.49	39.0%	-3.7%	-4.7%	65.1%	-45.8%
VSTOXX	21.06	61.34	37.4%	-13.0%	-5.3%	67.5%	-41.5%
Commodities							
Commodities (CRB)	562.5	n.a.	-0.1%	0.9%	26.8%	10.5%	-1.9%
Gold (Troy Ounce)	1 781	47.12	0.1%	-1.6%	-6.2%	24.9%	18.3%
Oil (WTI, Barrel)	63.04	30.79	-7.9%	-4.1%	31.3%	-20.5%	34.5%
Oil (Brent, Barrel)	65.55	30.53	-6.7%	-3.5%	29.6%	-23.0%	24.9%
Currencies (vs USD)							
USD (Dollar Index)	93.572	65.83	1.1%	0.6%	4.0%	-6.7%	0.2%
EUR	1.1678	34.14	-1.0%	-0.9%	-4.4%	9.7%	-2.2%
JPY	109.83	51.29	-0.2%	0.0%	-6.0%	5.3%	0.9%
GBP	1.3629	34.47	-1.7%	0.0%	-0.3%	2.8%	3.9%
AUD	0.7146	27.28	-3.0%	-2.5%	-7.1%	9.5%	-0.4%
CAD	1.2861	27.27	-2.7%	-1.4%	-1.1%	1.8%	5.0%
CHF	0.9173	47.35	-0.2%	0.5%	-3.5%	9.8%	1.4%
CNY	6.4998	39.18	-0.3%	-0.2%	0.4%	6.7%	-1.2%
MXN	20.380	33.41	-2.5%	-1.1%	-2.3%	-4.9%	3.8%
EM (Emerging Index)	1 714.1	32.35	-0.6%	-0.5%	-0.3%	3.3%	3.1%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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