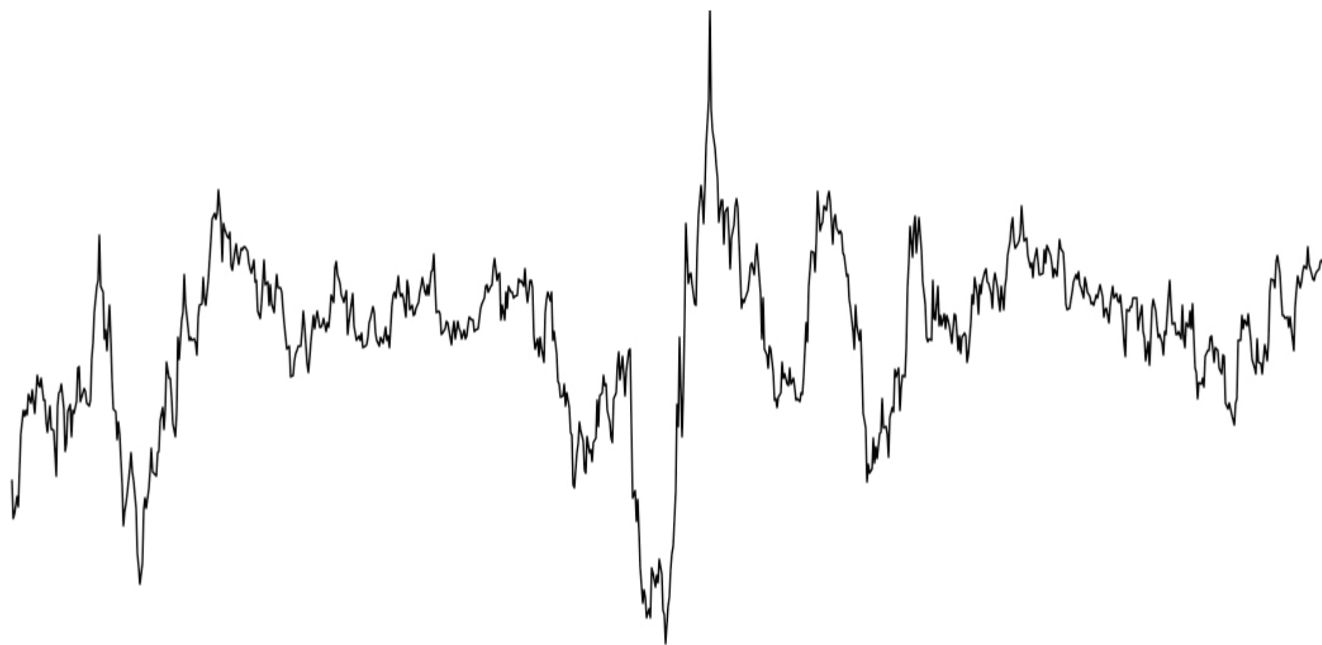
ALPHA SOURCES

OCTOBER 8, 2018



ARE BONDS SETTING A TRAP?

The easiest way for U.S. bond markets to entice investors to abandon their obsession with a flattening yield curve—and whether it'll soon invert—always was to steepen it. The spreads between 5y/10y and two-year yields have widened to 17bp and 30bp, respectively, about 10bp wider than at the end of August. More importantly, this move has occurred as a result of *higher* mid-to-long term yields.

A few basis points don't make a trend, but the combination of U.S. 5y and 10y bond yields pushing above 3% introduces a number of erstwhile dormant narratives into the mix. Perhaps the mythical neutral, or terminal, rate is higher than the Fed and markets think? Fed Chair Jerome Powell admitted recently that the FOMC probably doesn't know where this rate is. This argument makes little sense in the context of the dots, which seem to imply that a policy rate of a bit over 3% in 12-to-18 months time is deemed restrictive. But it makes sense if this signal is no longer relevant for markets.

The always optimistic David Zervos, the Chief Strategist for Jeffries, detects a shift at the Fed. "*The most important takeaway here is that the probability of an aggressive late-cycle curve inversion has plummeted. (...) Maybe Jay goes there if we start ripping toward 3500 in*

* / See additional charts on final page.

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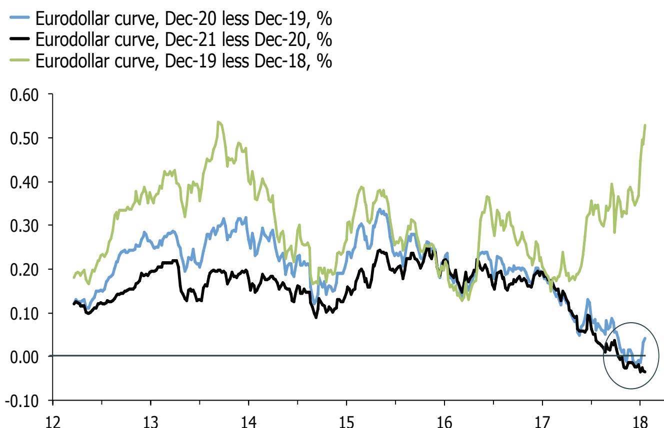
spoos, but it won't be because of the inflation or growth data." A more traditional bullish case is that productivity growth is either accelerating, or already higher than estimated. If this is true, the equilibrium level of interest rates is higher than the 3-to-3.2%, which appears to have been the assumption, up until recently. Contrary to Zervos' point, this simply would allow the Fed to continue its pace of interest rate hikes for longer than initially assumed without pushing the economy over the edge.

Unfortunately, the bearish argument is just as clear as the bullish case is. **The increase in bond yields could also be a sign that the Fed is behind the curve.** Perhaps the inflationary impact of higher oil prices and import-tariffs are finally feeding through to bond markets. And if it isn't that, maybe Mr. Trump's reckless fiscal policy is coming home to roost for bondholders. In either case, this is a not a good story for the economy or investors in risk assets. It implies that the Fed is about to go medieval, which won't be fun for anyone but those limit-long the Acme Cash-Only ETF™.

I am inclined to sell a kidney to buy the long bond at 3%+, though I concede that this call, which I have been nurturing all year, is now on notice. Meanwhile on the front-end, markets are teasing investors with the idea of buying a Dec 20-Dec 19 EDZs steepener. In other words, maybe the Fed's hiking cycle will extend into 2020, and the recession won't happen until 2021. This narrative is a good way to avoid the nagging question of when to sell equities next year, setting the stage for a further moon-shoot in Spoos.

All is not well in the otherwise so mighty U.S. equity market, though. The second chart below shows that higher yields and oil prices tend to be associated with falling multiples, which is exactly what is happening at the moment. With earnings growth at 15%+, this doesn't matter, for now. But it stands to reason that if momentum in EPS rolls over, even the majestic Spoos will struggle to extend its run. With that in mind, I am worried that bond markets are trying to spring a trap on investors; enjoy the steepener while it lasts.

fig. 01 / A special offer just for you — fig. 02 / Headwinds are building



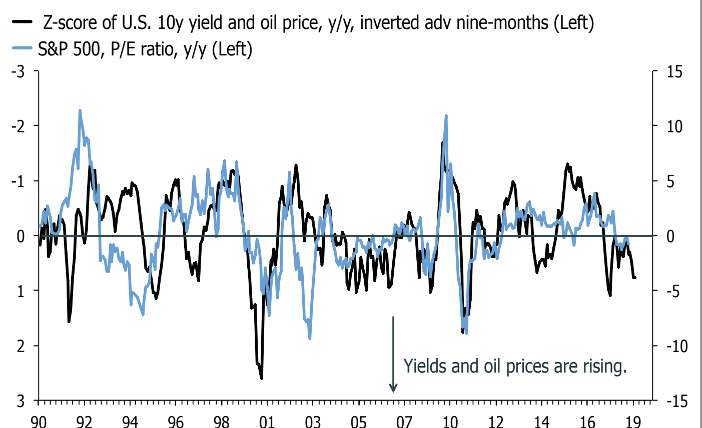


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fig. 03 / Markets are positioned for a steeper curve...

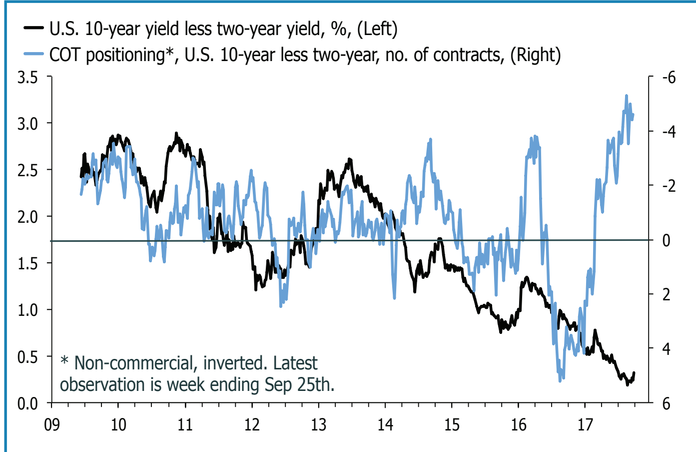


fig. 04 / ...But punters are also very short bond futures

fig. 05 / Earnings are left to do the heavy lifting for Spoos...

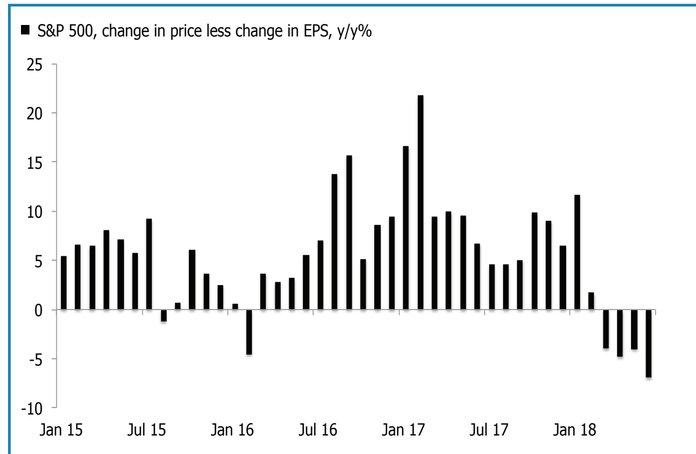


fig. 06 / ...Which is working well, at least for now

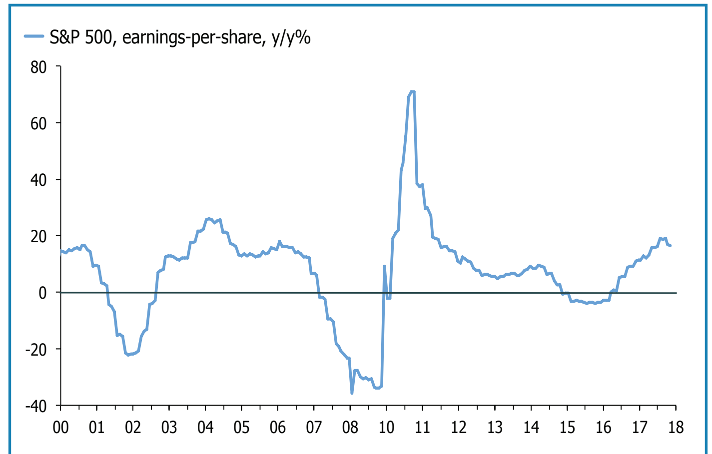


fig. 07 / Still time to sell bunds relative to the U.S. 10-year bond

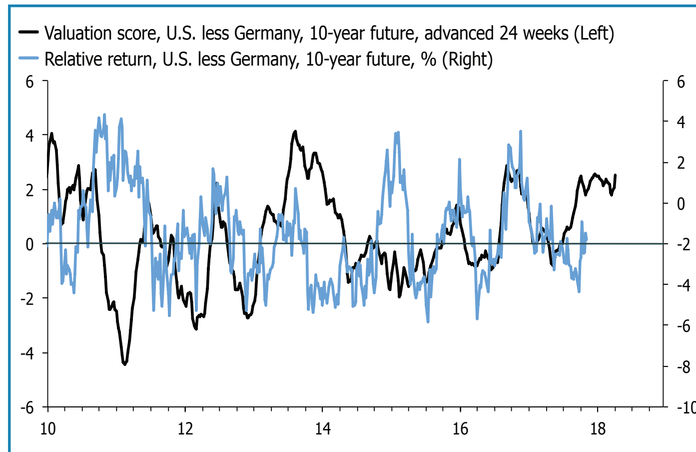
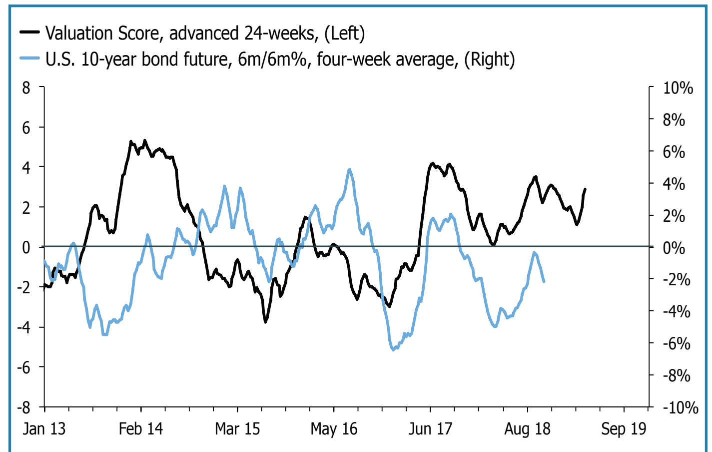


fig. 08 / My model still suggests that U.S. bond futures should rally



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