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Is Low US Government Issuance Depressing US 10-Year Yields?

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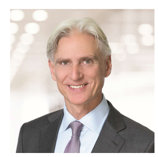
Markets were spooked mid-month as the Delta variant of COVID-19 surged across many parts of the globe. This made for a choppy period, but markets regained composure before month-end. The S&P 500 still managed to reach an all-time high in the second half and had a positive return of 2.4% (USD)[1]. The US outperformed Europe, with the EuroStoxx 50 returning 0.8% (EUR)[1].



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Despite Olympic hosts Japan doing well in the medals table, the same cannot be said for its market with the Nikkei 225 down -5.2% (JPY)[1], almost flat YTD. However, the worst performer of major markets this month was China. Having already underperformed relatively throughout 2021, this month's market rout pushed the MSCI China Index (USD) down -13.8%[1]. US-China relations deteriorated and China asserted a regulatory crackdown, which included Chinese technology, as well as private tuition companies. The VIX remains low at 18.22 and only reached 22.22 during the mid-month jitters[2].

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.** See Disclosure section for index definitions.

1 Bloomberg, 1-month return, 31 July 2021.
2 Bloomberg, 31 July 2021. The VIX© reached 22.5, 19 July 2021.

The path forward for US rates

The US 10-year Treasury yield continued its move down from a seemingly low 1.5%[3] at the end of June, to 1.2%[1] as of 31 July 2021. This is counter-intuitive because last month's Federal Reserve dot plot for 2023 to now, includes two rate hikes. Furthermore, in July the Federal Open Market Committee (FOMC) continued to suggest the Fed is moving towards announcing tapering plans, probably in late 2021.[4]

One explanation for the drop in yields is the normal seasonal decline in July/August US Treasury issuance. In addition, this year the US Treasury has benefitted from having raised substantial funds last year, not all of which have been spent, further reducing required issuance now. By maintaining bond purchases at the same level whilst issuance is down, the Fed is temporarily easing monetary policy. This puts significant downward pressure on yields. Once issuance and therefore the supply shortage eases, we expect rates to resume their move up. Importantly, however, the shortage of US debt may be exacerbated in the near-term by the debt ceiling that came into effect on 1 August, which limits total US debt issuance to its aggregate level as of 31 July 2021. It is extremely likely that the debt ceiling will be raised. Until then, US debt issuance is likely to be subdued and rates may struggle to rise in the face of continued Fed bond buying.

The start of a new capex cycle?

We are seeing an increase in capex that we expect will continue. Both the CEO Confidence Survey[5] in the US (lead Q4) and the Euro Area Business Climate Indicator (lead Q1)[6] are up. A vigorous capex cycle in this low interest rate environment, could have a significant multiplier effect, driving up hitherto stagnant economic productivity and economic growth. Moreover, a capex increase has typically led to a pick up in loan demand. Banks could decide to finance these loans by pulling reserves currently sitting idly in central bank accounts and lending these out to the real economy. This is likely to raise the "velocity of money" with concomitant upward pressure on both inflation and interest rates.

Investment Implications

We continue to be constructive with respect to global growth. Given the recent low volatility environment, we have been fine-tuning our portfolios by raising equities slightly, to ensure that our portfolios remain in line with their respective volatility targets. That said, amidst consensus optimism, we are considering how long the low volatility environment is likely to persist. As discussed in our last outlook, we are keeping a keen eye on any catalysts. These range from inflation to anti-trust policy, US-China tensions to virus variants, any of which may upend the current low volatility and trigger a spike.

In July, from a tactical stand point, we trimmed Financials and below we describe the rationale for this change:

3 Bloomberg, 30 June 2021.
4 Federal Reserve issues FOMC statement. Press Release. 28 July 2021.
www.federalreserve.gov/newsevents/pressreleases/monetary20210728a.htm
5 US Bureau of Economic Analysis (BEA), Conference Board, data as of 9 July 2021.
6 European Central Bank (ECB), Macrobond, data as of 9 July 2021.

Financials

We remain overweight Financials and have been since November 2020, in keeping with our cyclicals theme and tilt to value. However, we trimmed our position in July to take some profit. We implemented the position last November, in anticipation of a synchronised return of global growth, with banks amongst the highest sector beta of earnings to global GDP growth. At the time, valuations were also depressed in absolute terms. However, now the sector appears to be slightly expensive.

Tactical positioning

We have provided our latest tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Value				■	
US Growth		■			
Eurozone			■		
Germany				■	
UK				■	
Japan			■		
Asia ex Japan			■		
Emerging Markets			■		
LatAm			■		
Global Infrastructure			■		
Global Property			■		
Global Financials				■	
Global Conventional Energy				■	

Asset Class	--	-	=	+	++
Fixed Income					
IG Credit		■			
US High Yield			■		
European High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries		■			
US Inflation			■		
German Bunds		■			
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Gold			■		
Industrial Metals			■		

Source: MSIM GBaR team, as of 31 July 2021. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation, or specific needs of any individual investor.

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Capex: Capital expenditure – the funds a company expends on purchasing, upgrading or maintaining fixed assets such as property, plant, equipment.

Dot plot: This is a "forecast" released by the Federal Reserve on the projected fed funds rate. It is based on a voting system with each member of the Federal Open Market Committee (FOMC) determining their own projection of where the fed funds rate should be at the end of each year. These are collated into the dot plot, which presents the distribution of "votes" for each year end between the members, with the market looking at the median forecasted level of rates at every year end.

Euro STOXX 50 Index: Provides a blue-chip representation of supersector leaders in the Eurozone.

GDP Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports.

MSCI China Index: This free-float adjusted capitalization-weighted index is designed to measure the performance of China-based equities.

Nikkei 225 Index: This price-weighted index is comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX®: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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