Continuation of carry

News Analysis

by
Mark Dowding

Partner, Co-Head of Investment Grade

May 2017

A benign global backdrop is serving the carry trade well but higher rates may well spoil the plan.

Risk appetite has rebounded in the past week as worries surrounding the Trump Presidency and political turmoil in Brazil have faded into the background. Equity markets have reached new all-time highs, which has helped sovereign and corporate credit spreads recoup last weeks' losses, whilst volatility indicators such as VIX returned to levels last seen in 2006. Against this sunny backdrop, it is perhaps surprising that core government bond yields are little changed in recent days, as the flight to quality has dissipated. We continue to look for US yields to move higher, led by the front end of the curve, but we feel that we need to have some patience in this view for the time being.

Federal Reserve (Fed) Minutes remain fully consistent with a June hike and further normalisation in monetary policy to follow thereafter. Real interest rates remain negative and the economy is at, or close to full employment. With equity markets driving positive wealth effects and the US dollar somewhat weaker than the start of the year, we believe that as long as the growth outlook does not darken, then the FOMC would like to gradually return the Fed funds rate towards neutral, with hikes on a quarterly trajectory. In this context, we believe that the 'dot plot' at the June meeting will be unchanged since March, noting that since the last meeting, labour market data has surprised to the strong side, even as inflation data has surprised on the soft side. With respect to inflation, we would highlight that recent softness has been largely a function of telecom providers offering large data bundles at discounted rates and this represents something of a one-off event. With central bank policy focusing on inflation 12 months out, as long as wages trend modestly stronger then the Fed is unlikely to pay too much attention to this. However, hedonic factors such as this are often not incorporated into CPI figures and at a time of technological advance there may be good arguments to suggest that inflation is currently being over-estimated – though the corollary of this is that the pace of economic activity and productivity is being under-estimated and consequently this could currently call for higher (not lower) levels of interest rates.

Elsewhere the Minutes also gave more detail regarding the Fed balance sheet. In line with the views we have been expressing, it seems that the Fed is committed to start tapering its balance sheet by setting caps on the reinvestment of maturing securities it owns later this year. These caps would come down gradually over time, with the Fed eager to minimise the market impact of this change so as to avoid a dislocation such as the 2013 taper tantrum. Previously the FOMC has communicated that it will defer balance sheet adjustment until after rate normalisation is well underway and we have thought that this could come in Q4 after hikes in June and September. It is now possible that tapering may be pre-announced at an earlier point, subject to economic data. Analyses from entities such as the Kansas Fed have suggested that the whole of the taper would be worth a similar amount to 25bps in rate hikes over a progressive 2 year period. Seen in this light, worries around balance sheet reduction may be over-hyped, but it is true that the Fed is uncertain on this topic as there is no clear historical precedent to analyse. However, what can be concluded is that, for now, a robust economy, a benign global backdrop and a broadly bullish environment in global financial markets are all giving the Fed plenty of flexibility to manoeuvre policy as they see fit.

European markets have been relatively quiet in the past week due to public holidays. The German IFO index of business sentiment rose to an all-time high since 1991, highlighting a boom in the German economy. However, the European Central Bank (ECB) continues to reiterate its dovish stance and consequently Bund yields remain unchanged and risk assets in the region continue to rally. UK markets were overshadowed by the tragedy in Manchester, though with respect to UK policy, Theresa May’s U-turns on manifesto commitments might be taken in Brussels that she will be less of an Iron Lady than she would currently like voters to believe. We continue to think that all roads will lead to a hard Brexit, regardless of the size of a Tory majority and moved short sterling versus the euro earlier in the week as we believe that the pound has priced in too much good news since the election announcement.

Looking forward, we continue to see the global backdrop as benign and favouring a continuation of carry trades over the summer. Although volatility indicators are at alarmingly low levels, we do not detect too much greed and complacency in markets just yet and it remains striking to observe the number of equity bears outnumbering bulls notwithstanding the ongoing climb in equity indices. We continue to see higher rates as the biggest risk to this view and are positioned to benefit from higher yields through short positions in Eurodollar contracts in the US and in long dated rates in the UK. In meetings with policy makers in Japan in the past week, we were struck by how often the topic of labour shortage came up – with the example of Yamato being cited as the #1 delivery company in the country who are having to stop next day deliveries due to a shortage of drivers being available. This stands as a reminder that unemployment rates cannot keep falling indefinitely and although the Phillips Curve remains very flat, ultimately labour shortages will either mean wages need to rise or (in the Japanese case) services will need to be cut.

It was tempting to paste a picture of a Yamato delivery truck as a ‘picture of the week’, yet on a slightly different note, we thought it would be amusing to share a graphic showing a surprisingly strong correlation to English Premier League football team performance versus Brexit referendum results instead. Last year we wrote how Brexit for the Remainers involved 7 stages of grief and that having confronted shock, anger, denial, hope (of a 2nd referendum) and depression, we now seem to have reached the point of acceptance with respect to leaving the EU. However, we continue to be struck by the thought that the template for negotiations is going to be extremely challenging and ultimately a messy divorce, which leads to a hard Brexit and will require material fiscal easing to mitigate the pain. Ultimately this process may be just as challenging in places like Sunderland and Middlesbrough as it is in Tottenham and Arsenal…but at least Chelsea won the league ☺.

.