The Quandary Of Rising Yields

Louis-Vincent Gave
lgave@gavekal.com

Imagine that you had been told at the start of this year that equity markets in the likes of Argentina, Turkey and South Africa would fall by as much as half, that the renminbi would slide by -10% against the US dollar and that Chinese and Hong Kong stocks would be back in a bear market. You would probably have assumed that long-dated treasuries would make a great investment. Yet, here we are, with 30-year treasury yields up about 50bp this year and looking to break out above the technically important 3.25% level.

It is perhaps even more noteworthy that this latest rise in US government bond yields has been accompanied by a retreating US dollar. A similar pattern was seen in January, only in a more pronounced fashion. Such movements are typical in emerging markets when investors signal that the policy mix is not quite right. So what should we make of this latest rise in US bond yields?

Rising US economic growth does not seem a likely explanation for higher treasury yields

One explanation puts the move down to accelerating US economic growth. I am not persuaded by this argument given that OECD leading indicators have rolled over, global growth is ebbing (especially in China and Europe) and both the US real estate and auto sectors look to have topped out. More broadly, US economic data has, of late, underwhelmed. Thus, it seems unlikely that the rise in yields has been prompted by an upgrade in US growth prospects.

The disruption from tariffs may be inflationary, yet the US economy also faces a series of deflationary forces

Another option is that US yields are rising due to growing inflationary pressures. Taking a firm stance on this point is challenging as we seem to be approaching uncharted territory. On the one hand the US faces deflationary pressure from EM currency devaluations, falling commodity prices (ex-oil), a rise in inventories before import tariffs are imposed and a rolling-over of demand for housing and autos. On the other hand is the question of whether the Trump administration's attempt to disrupt supply chains and bring manufactured production home at a time when the job market is tight, could end up being a powerful inflationary counter-force. This is a hard call to make given that the coming level of disruption to supply is still unclear.

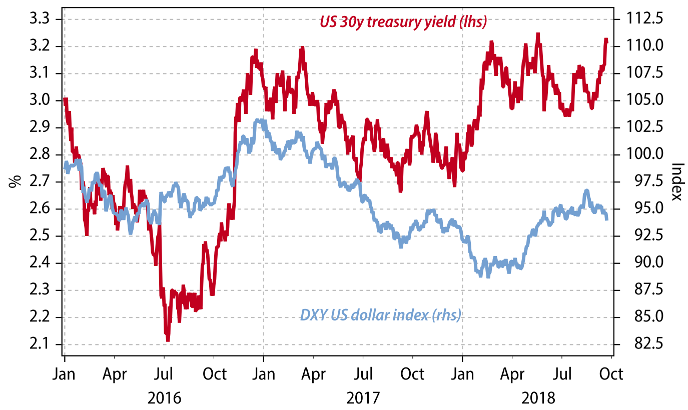
Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US existing home sales unchanged MoM at 5.34mn in Aug	Lower than 5.37mn expected	Weak housing data continues; rising interest rates are hurting; underweight US homebuilders
US Philly Fed business outlook survey rose to 22.9 in Sep, from 11.9 in Aug	Higher than 18.0 expected	Business expectations fell vs current conditions; expect yield curve to flatter further
Eurozone consumer confidence fell to -2.9 in Sep, from -1.9 in Aug	Worse than -2.0 expected; lowest since May 2017	Trade & political tensions weigh on outlook for growth & employment; likely to continue
Japan CPI rose 1.3% YoY in Aug, up from 0.9% in Jul	Above 1.1% expected; CPI ex-food rose 0.9% YoY, from 0.8%	CPI trending in right direction although still distant from BoJ target; expect prolonged pause

The dollar and treasury yields go their own way

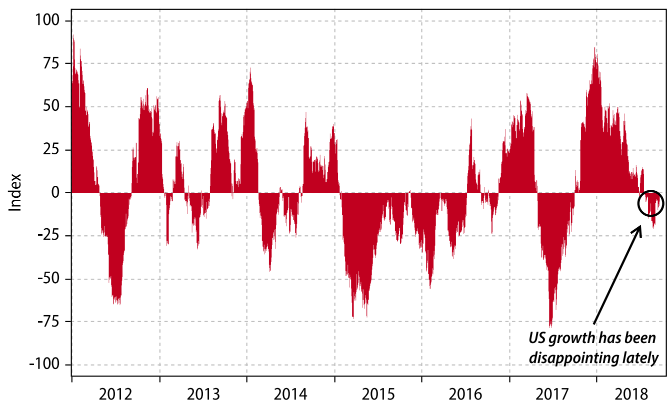
US 30-year treasury yield & DXY



Gavekal Data/Macrobond

The US economy is starting to disappoint

US Citi economic surprise index



Gavekal Data/Macrobond

The most persuasive argument for higher yields is that the market is reacting to the prospect of ever-higher US deficits

The final explanation is that investors are starting to worry about US deficits and debt, and on this score the picture is alarming (see **The Ogre Eating His Own Children**). Concern over rising deficits certainly explains why the dollar has failed to break out on the upside despite rising yields and the EM battering. Yet if rising US budget deficits are the main reason why US bond yields are no longer declining on news that would usually be considered deflationary (EM meltdown, disappointing CPI numbers, a strong dollar measured on a year-to-date basis) then the investment environment has shifted. This week White House economic adviser Larry Kudlow said the US fiscal deficit would keep on widening and that assumed solid growth! On this basis, we can expect US yields to keep making "higher lows and higher highs".

We are at a crossroads on the yield question and investors must make a choice, as the implication of the scenarios outlined above are quite different

Thus, we are reaching a crossroads and investors have to make a choice. Are US yields rising because growth is accelerating? Because inflation is accelerating? Or because US government deficits are starting to spin out of control? Each scenario comes with its own investment implications. And needless to say, of the three scenarios, the third might well have both the highest odds, and the least attractive long term investment consequences.