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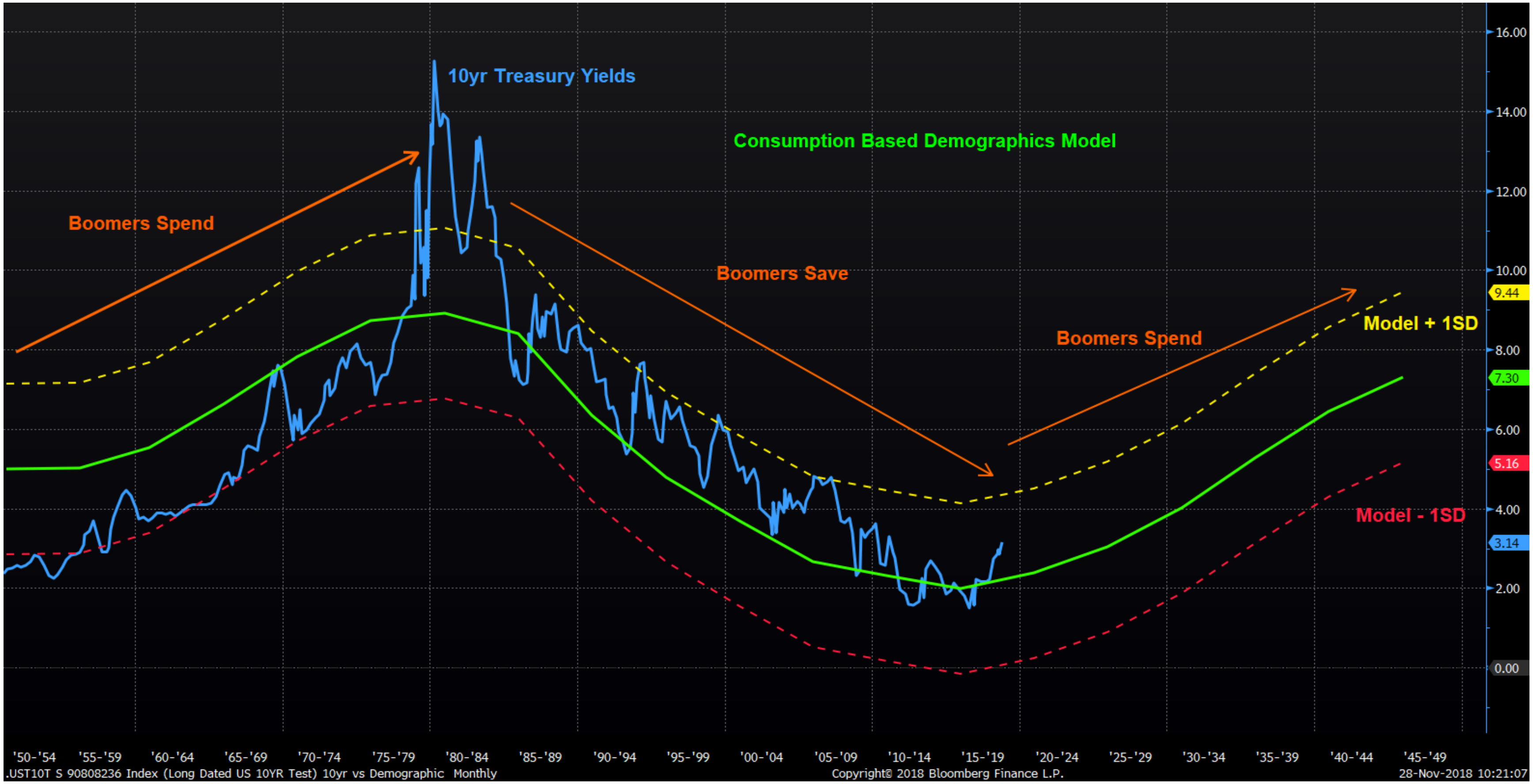
November 2018

The Outlook for Treasuries

Big picture we believe that the low in Treasury yields occurred in 2016 and demographics dictate they move higher

The trend is clear but this is glacial stuff



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But the move was never going to be linear

Shorts in US fixed income have been our favourite way to express a tightening of financial conditions

But given the excesses central bank policy has created in the market and real economy normalisation was never going to be smooth. Two steps forward one step back!

In particular, the circularity between stocks, housing and bonds yields makes outright fixed income more complex

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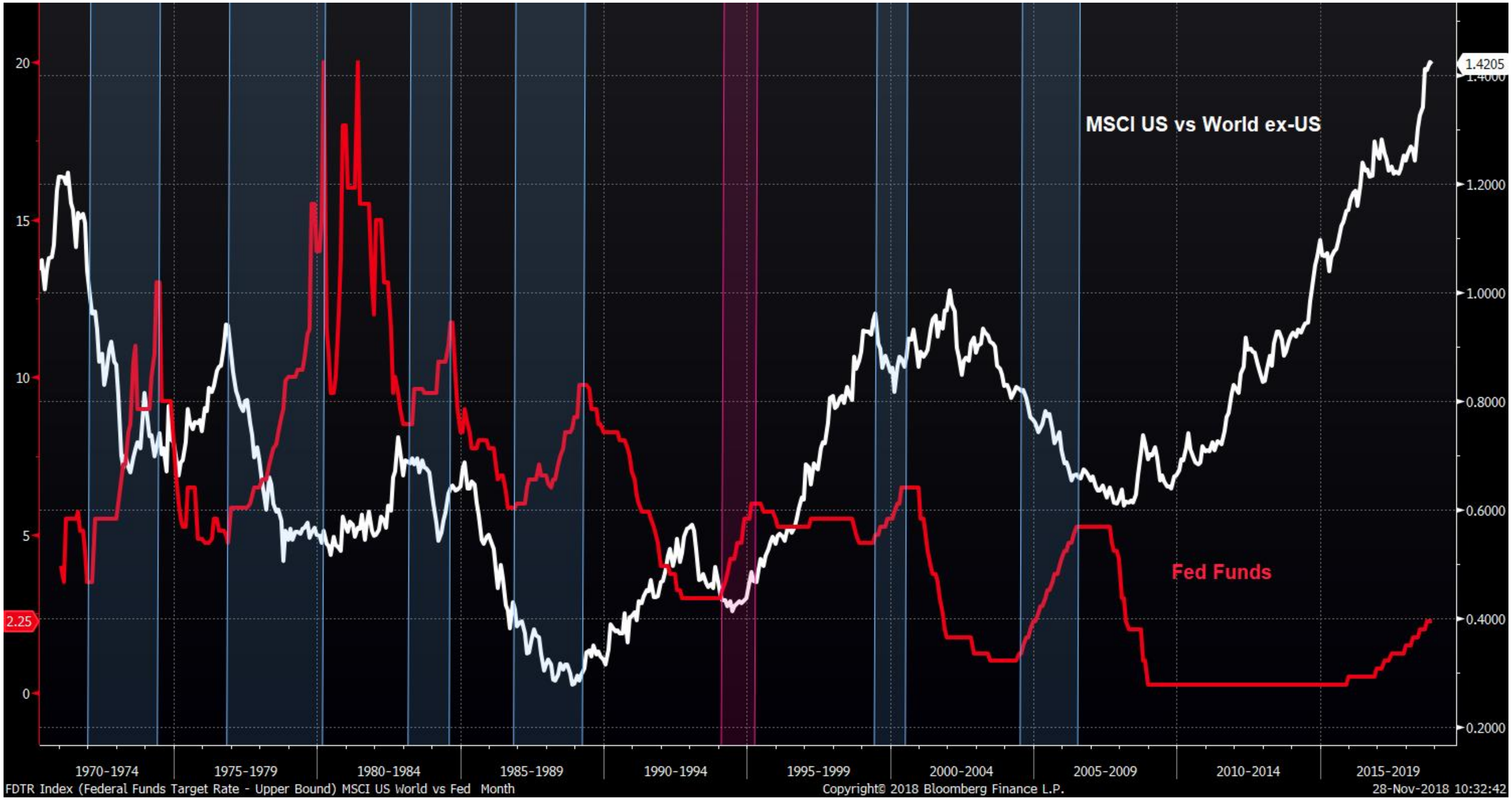
In the US, this equity cycle is unlike any other
Have we created a reflexive bubble?

A timid Fed and poorly timed fiscal spending has led to unprecedented outperformance of US stocks which along with repatriation, has sucked liquidity into the US



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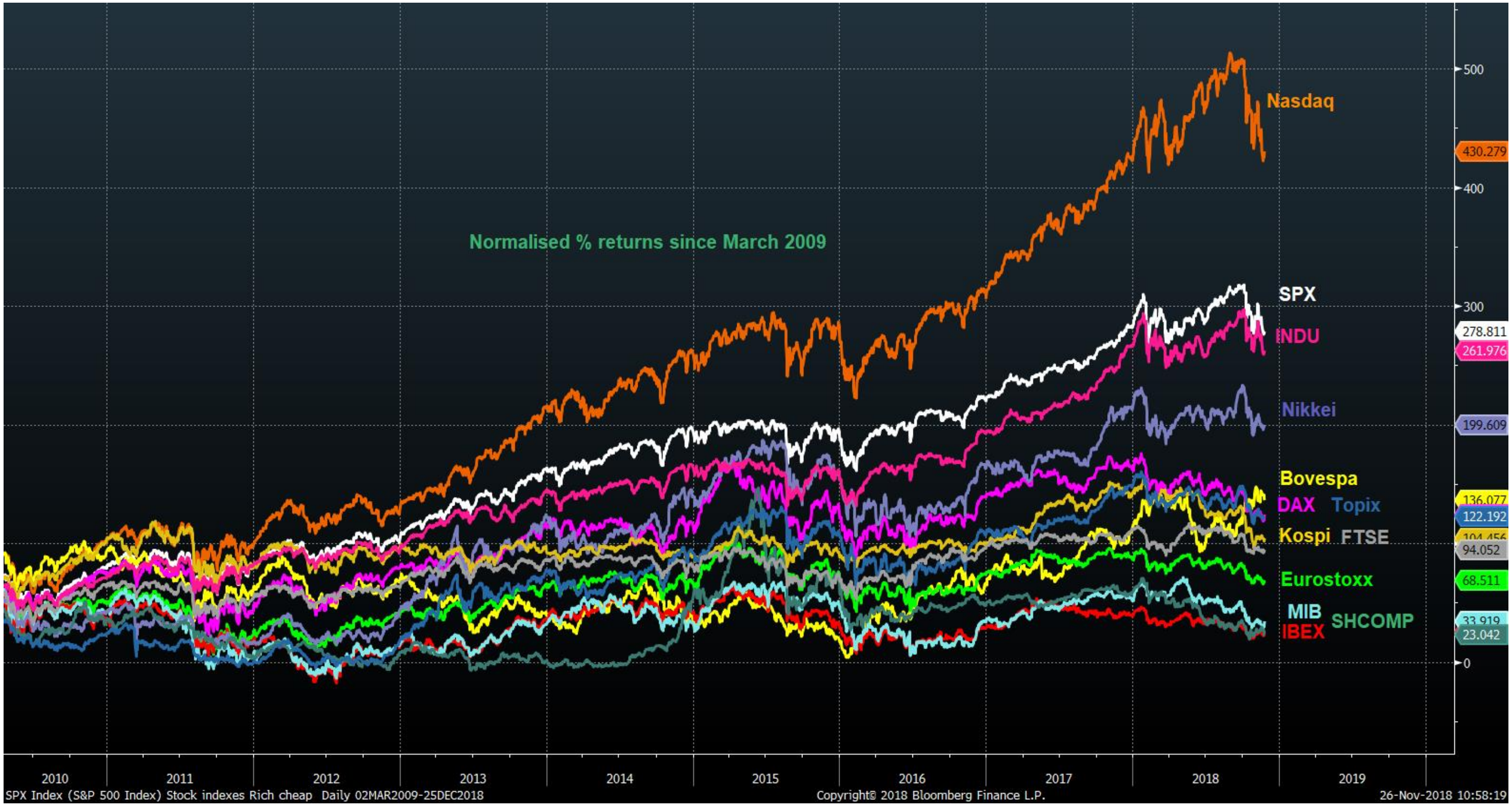
It's pretty clear where the excesses are!



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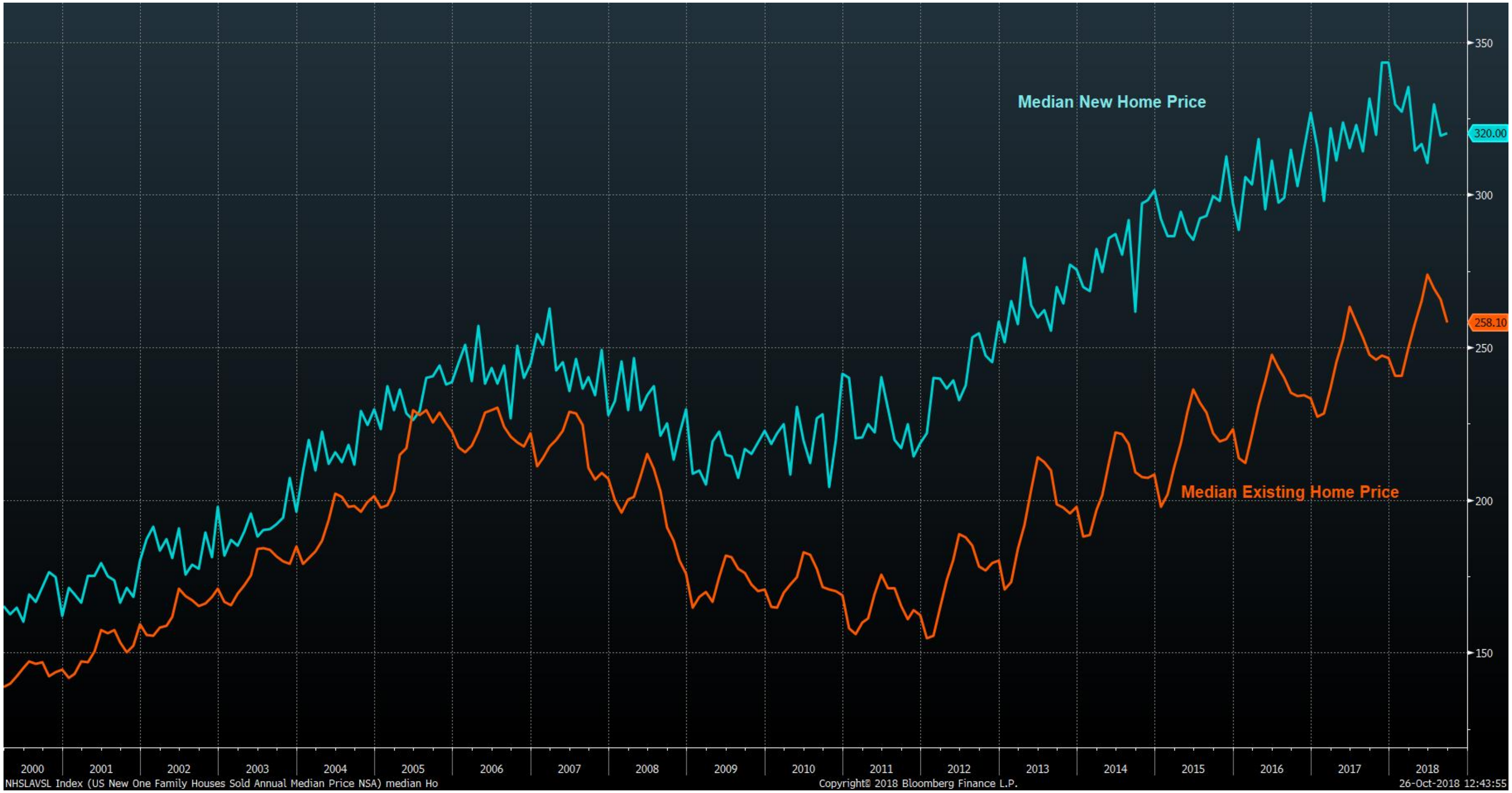
Unfortunately, the excesses aren't just in securities markets
We have pushed house prices back to bubblicious levels

Negative rates and QE have massively inflated house prices
Even allowing for a change in the mix in new homes, prices are in excess of the 2007 bubble



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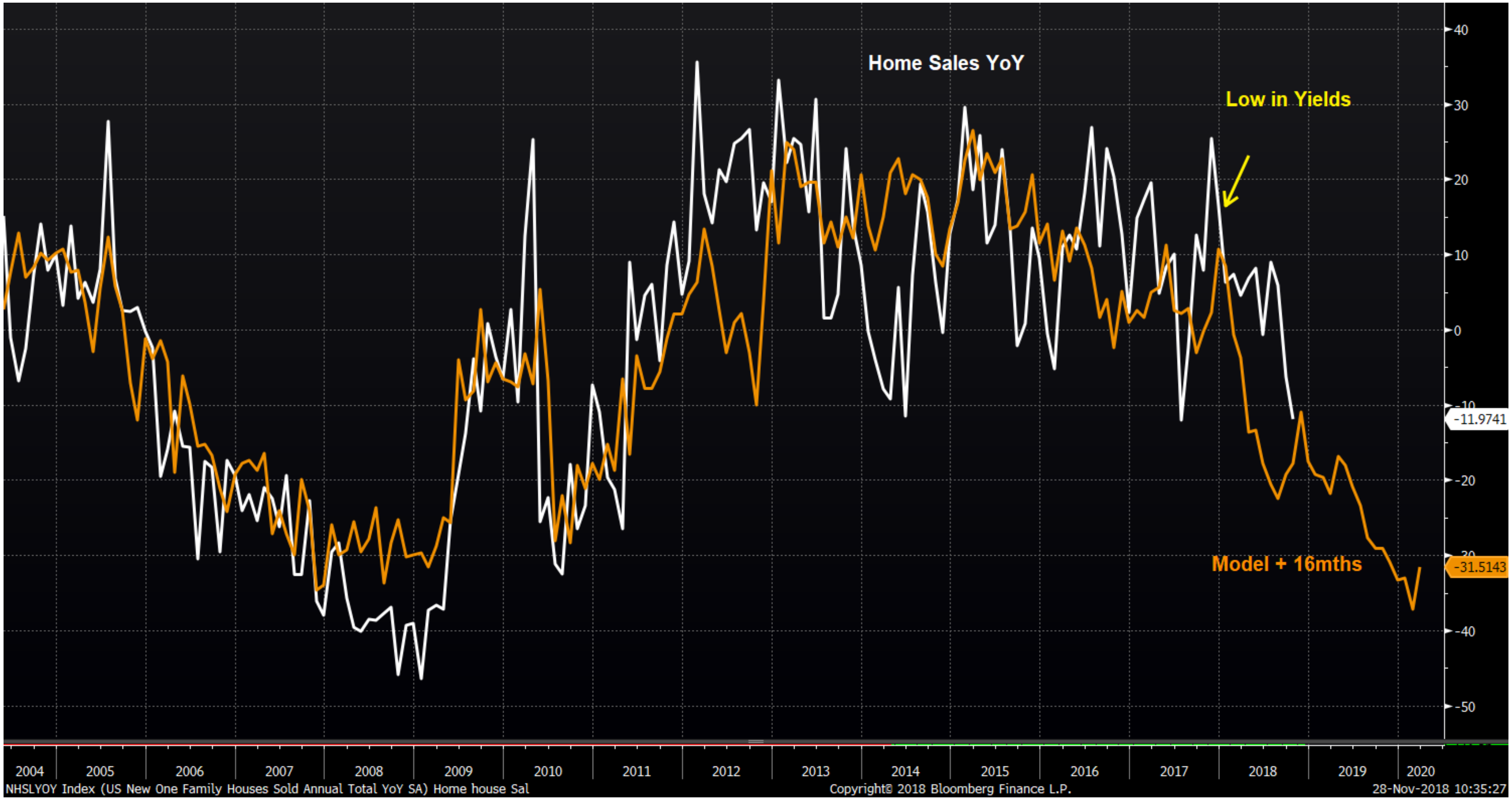
This lack of affordability is crushing housing activity



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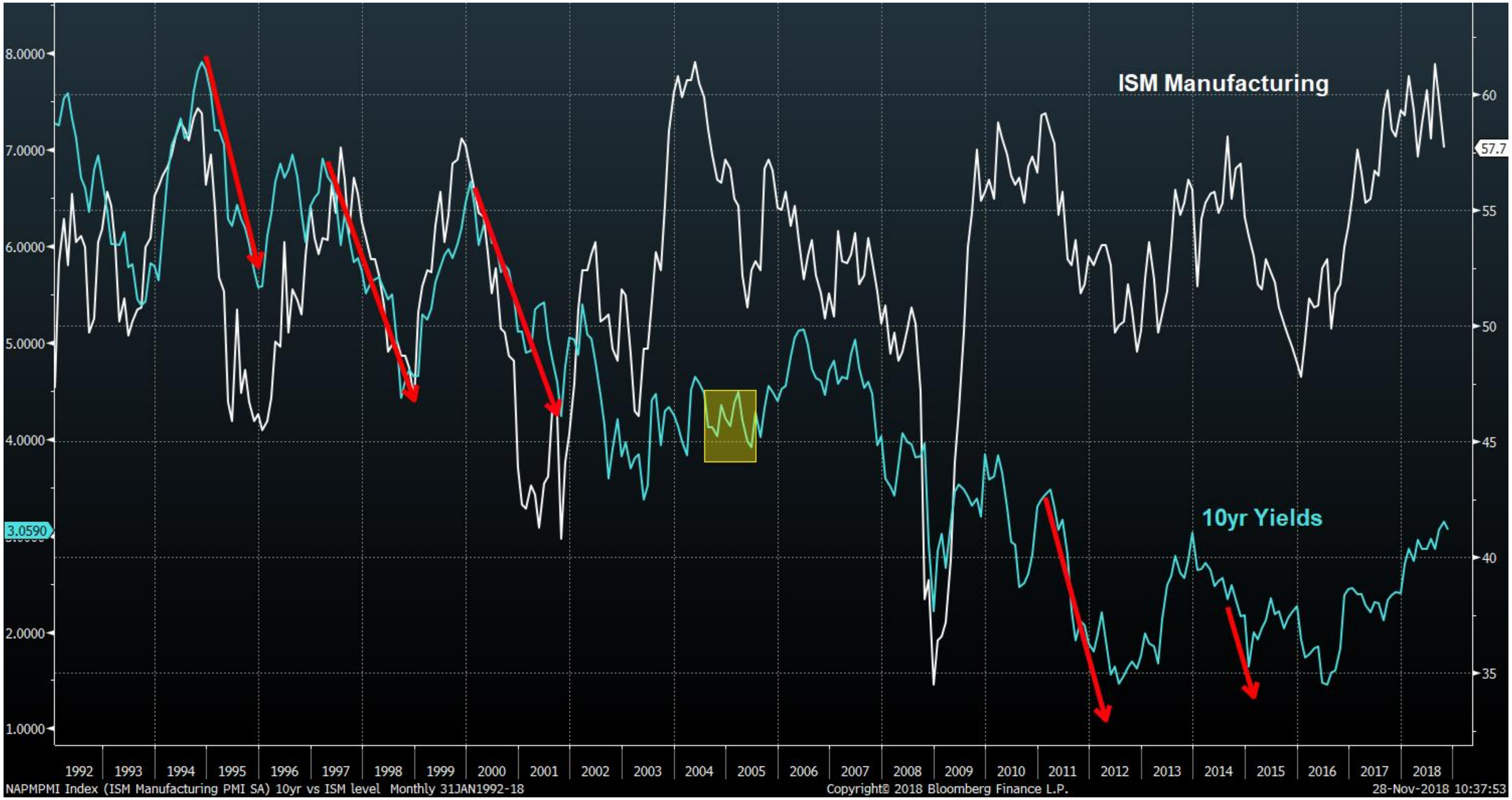
As the soft data corrects it's tough to be short Treasuries

ISM at 60 is commensurate with 4% YoY GDP growth and we are growing at 3%
ISM really should be 52 and instead we believe has been inflated by



So if you want to buy what should you buy?

Well so far the level we broke in 30 year yields is holding

It is worth noting that despite the weakness in US equities we are still holding above the 100 month moving average and the neckline of the inverse head and shoulders

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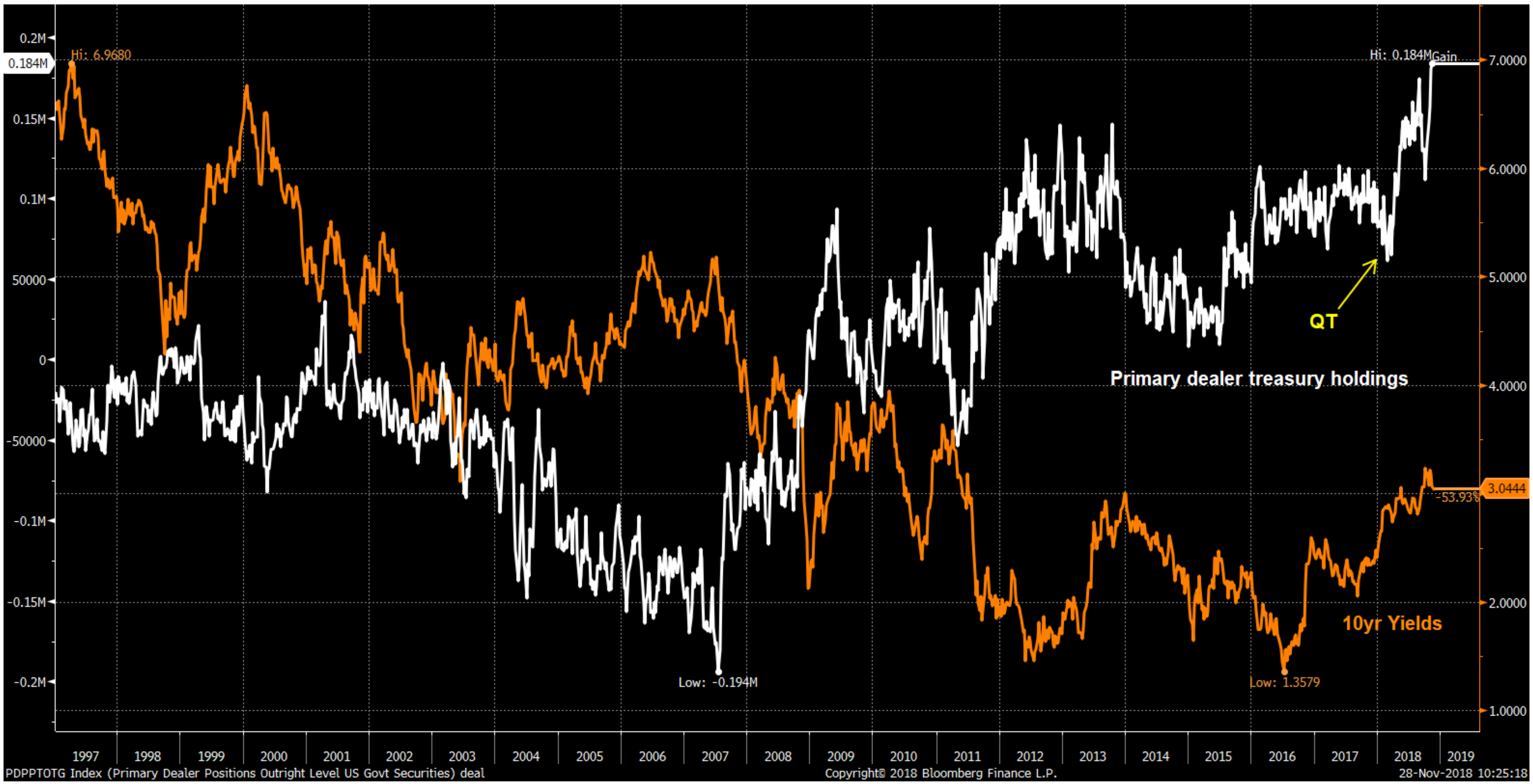
One reason is that supply has become a major issue since the start of QT. This leaves us wary of the long end



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So for our professional accounts we've switched to steepeners

Despite our growing macro concerns we are very nervous especially about the long end of the curve. Hence why we've suggested taking profits on shorts and instead switched to forward starting swaps on the curve

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Timing

The bubble stocks are overdue a bounce

Amazon is a "classic bubble" and once the bubble bursts you get a sharp sell-off
But this is followed by a bull trap bounce back towards the neckline, which fails

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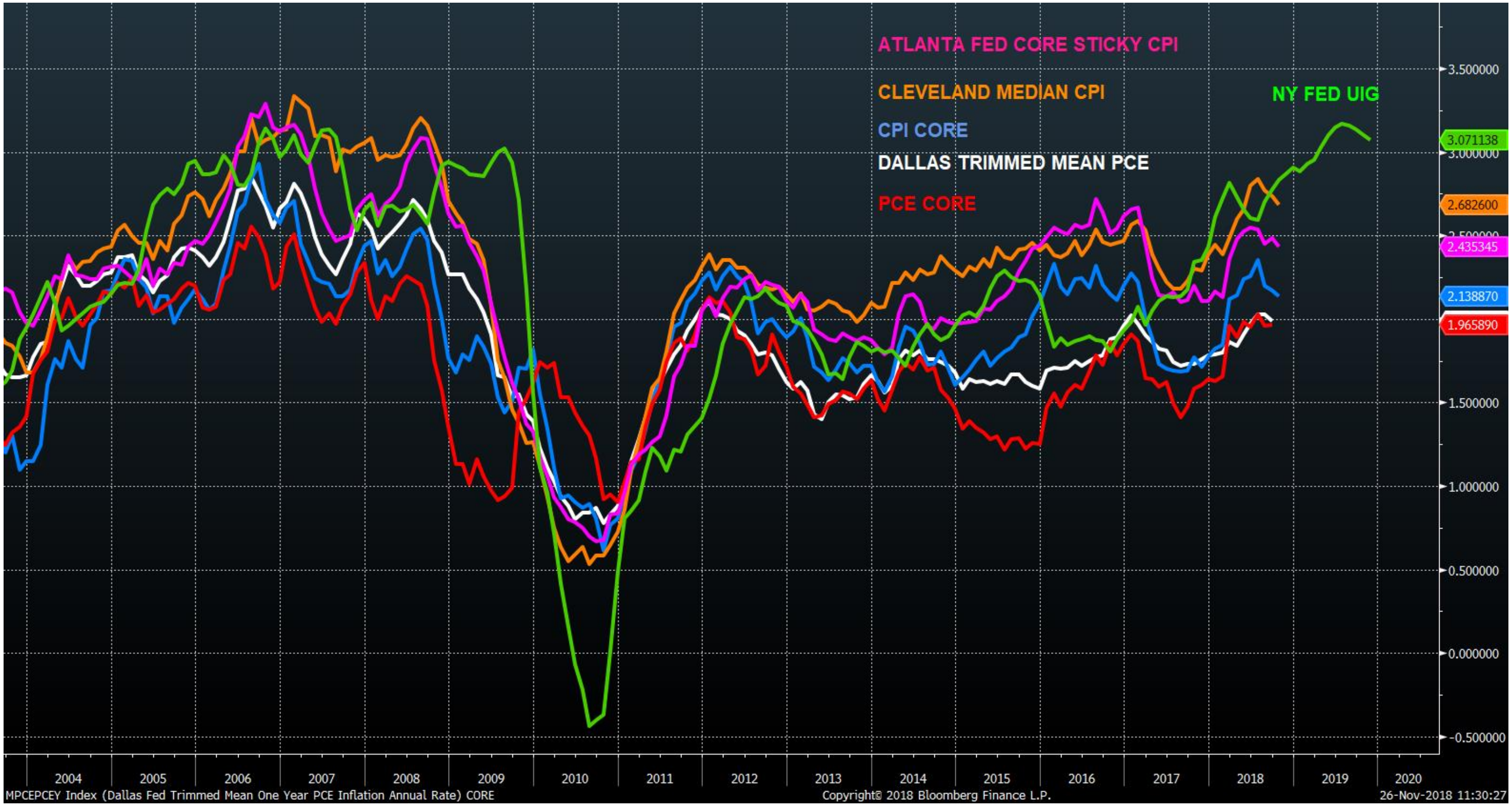
There is also the issue of a reacceleration of inflation in Q1

"November data indicated that strong input price inflation persisted across the private sector economy, which survey respondents often linked to higher costs for transportation and raw materials (particularly metals)" Markit Composite PMI



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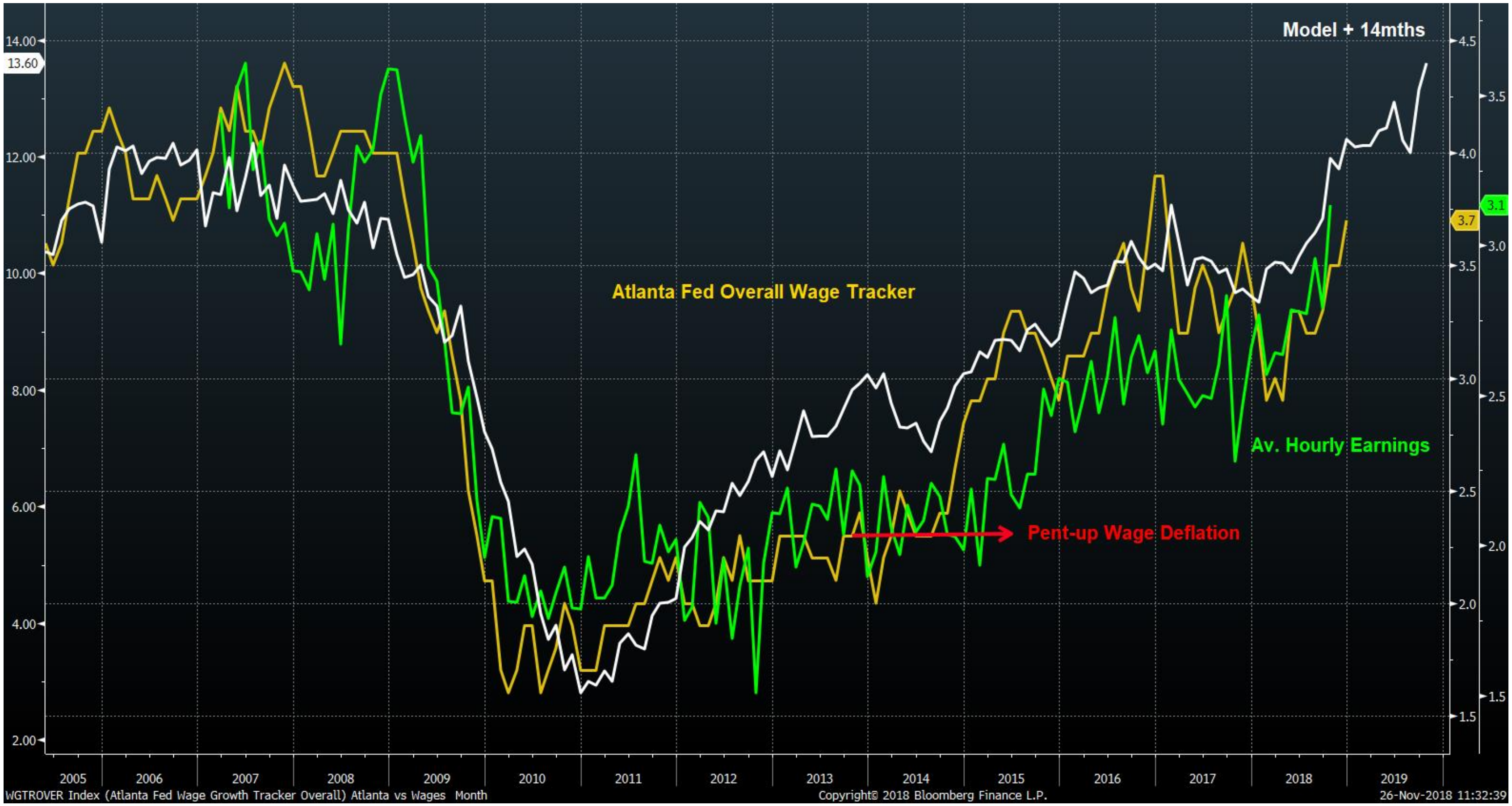
And finally we face accelerative wage growth

"Labor shortages were broadly noted and were linked to wage increases and/or constrained growth." Beige Book



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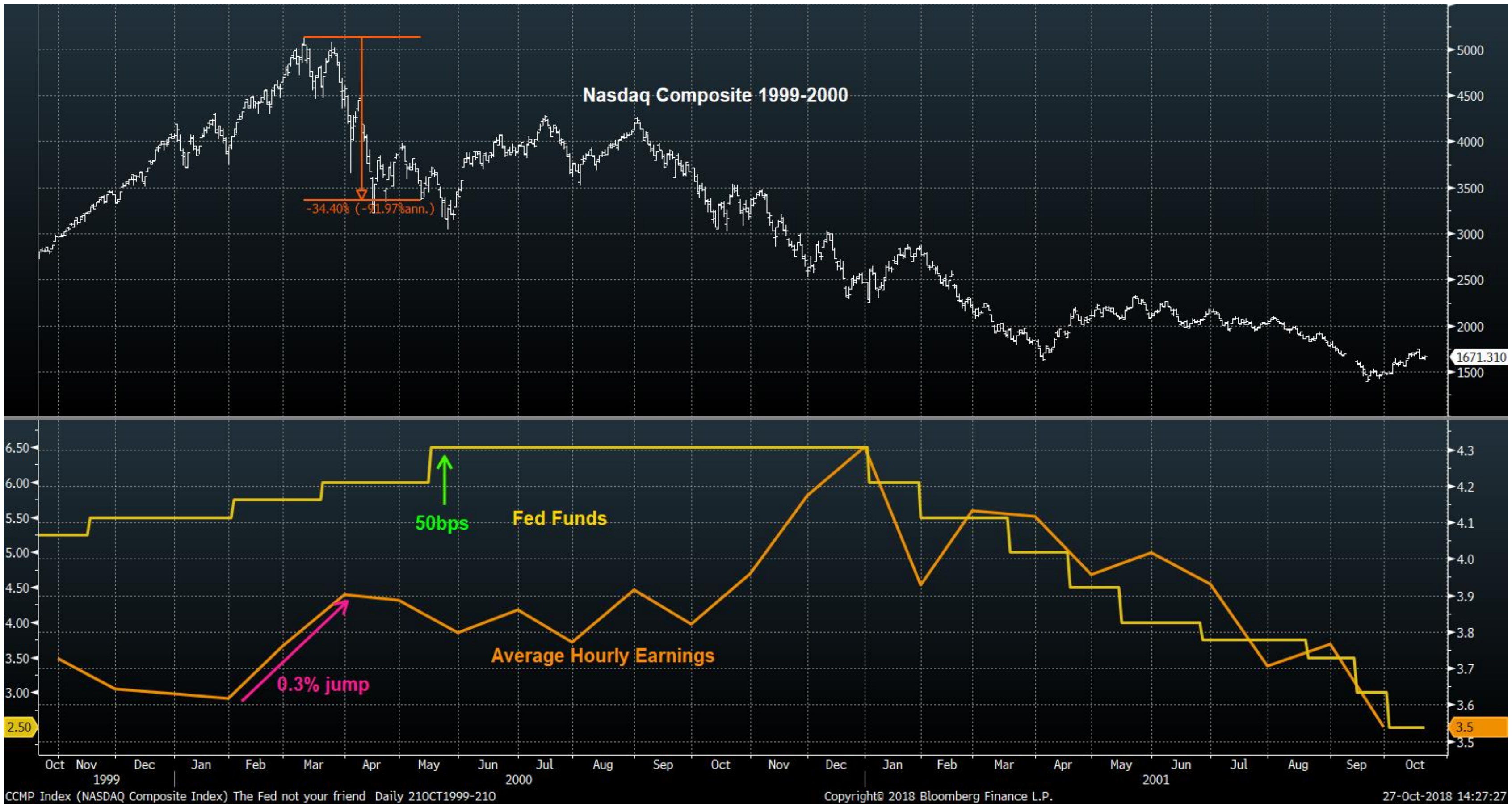
This suggests that while we don't believe the Fed has the guts for a fight in the short term "nasty Fed" is a risk



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