Sanctum Wealth Management

Sanctum View

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Rotating to the Old Normal

- **Global growth data is strong and getting stronger**
- **The upward pressure on bonds yields is here to stay - think a 10 year bond yield of 3%**
- **Rotation away from last year's winners of technology and duration**
- **The new portfolio winners will be income producers: back to the Old Normal**

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Last week's flash tantrum in markets was more than just a flash: it is the spark to a flame. This week saw another jump in US bond yields and very little evidence of subsiding volatility: the MOVE index of implied bond option volatility is still at 69.4, compared to 45.9 at the end of January. Fuelling the inflation concerns that had been bubbling beneath the surface until now was a robust set of US labour market numbers. On Friday, the US jobs market posted a recovery after a series of disappointing readings. It is looking like the COVID drag is finally fading. The 370k new jobs added in February was the strongest reading since October. Year to date, 545,000 jobs have been added, which erases the big drop of 306,000 recorded in December.

The labour market now joins several other datasets that have been surprising on the upside. In aggregate, the US Citi Economic Surprise Index climbed to 85. While that is down from the high of 250 in July, it is up from 50 at the start of the year. Through the cycle, it typically oscillates around zero, with readings above 50 taken to be signs of strong economic expansion.

We are now even more strongly of the view that yields need to rise to levels closer to 3%. Taking a longer-term perspective on Treasury bonds as an asset class, we note that even the current level of 1.55% is far too low. We have commented on this recently, pointing out that the poor 7-year auction (where the bid-to-cover ratio and tail were the worst in decades) is the market's way of signalling that it finds very little value in the bonds. While it is a short-term measure, the futures market's net open interest turned negative this year and has dropped even further into short territory in March.

It is not a sound strategy to allocate capital to an asset that is delivering a negative real return in more normal times. That is where we are. In the TIPS market, the 10Y inflation breakeven rate is being priced at 2.23%. This is a very close approximation of the average inflation outcome over the past decades and is also a very close approximation of the average breakeven rate that held sway in the market pre-GFC.

It is not correct to add a term risk premium to the inflation rate to arrive at a fair value. However, the direction of travel is instructive. Given that real yields at the short end is even more negatively-yielding in real terms than the long end, and if we assume further that a return to the "old normal" will effectively drive rates to be at least flat to inflation (to be zero in real terms), adding a term premium will leave the "correct" rate of the 10Y treasury beyond 3%.

What does it mean for asset markets? Turning to the market and observing the most recent price action in bonds and technology stocks begs why such a vehement reaction occurs as some key market indicators return to normal? From the low in August, US nominal rates have risen by 100 basis points or more, and real rates are up about 40 basis point, give or take.
These are not abnormal by historical standards if one accounts for the point in the cycle where the US economy finds itself.

The switch from growth to value could have a lot more room to run. One of the most telling reversals YTD has been the S&P500's Momentum factor dropping 6% while the Value factor has gained 5%. This is a clear indication that the market is looking for something different from the recent past's paradigm that technology stocks provide defensive qualities.
In comments made last week, Fed Governor Powell suggested that the Fed is not alarmed by

the return of a normal level of growth and inflation. As the effect of COVID fades and the economy starts taking the shape of previous recoveries, the rotation to value is in effect, just a reflection of the same event. The valuations reached by the technology sector will continue to be questioned, and the merits of lagging value stocks will come to the fore.

Bond duration is not safe – but equity income could be. Given the view on yields, it is worth noting the scope of the return downside of interest rate exposure. Even a slow drift higher to 3%, if it occurs over two years, still leaves the investor out of pocket by almost 7% over the period. It is now possible to find equities that are paying dividends much higher than the yields on bonds. The sweet spot may be between 3%-4% dividend yield in larger energy names or consumer stocks. Both will have a higher income stream than bonds and will provide upside to prices in the event of reflation (the opposite of bonds). Such a strategy could be viewed as risky in the short term – substituting bonds for stocks – but for investors who can tolerate the up and downs, it is a much sounder call than the alternative of investing in bonds with negative real yields.

The outlook for EM fixed income is susceptible to the same fate as DM government bonds. In EM bonds, several factors are at play. In USD-denominated bonds, the BofA index of BB-rated sovereign bonds currently offers a spread of 290 basis points over US treasuries, the same as at the end of January but up from the low of 270 in early February. The simple math is that a rise in US yields will erode capital value in EM bonds too. There is a minimal prospect of spreads tightening to compensate for the losses that will accrue as yields rise.

In Emerging market local currency bonds, much depends on domestic factors. Issues like COVID response will play a role, as well as the effect of rising commodity prices on terms of trade. However, the trend most recently is for local currency yields to rise. By our calculations, the blended yield on a basket of 15 EM local bonds has increased by 50 basis points YTD, from 4.4% to 4.9%.

Opt for safety in strategic bond funds: With the outlook for conventional bonds dim, another option for investors is to opt for the relative safety of bond funds that could play the volatility of the markets. With yields low everywhere, these vehicles will be unspectacular but with much less downside.

The combination of stimulus and a normalising economy will fuel a massive rotation in the equity market. A strong vaccine response in the US makes it reasonable to expect that even upgraded growth forecasts might still prove to be on the conservative side. In this climate, it is best to keep interest rate risk exposure low and look for equity market opportunities with a more old-school feel to them: dividend-yielding plays and commodity-driven stocks over the expensive technology sector.

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