The Major bond letter

#30. Score draw

Free to View
Fixed Income - Rates

Global

Steven Major, CFA
Global Head of Fixed Income Research
The Hongkong and Shanghai Banking Corporation Limited

In what was setting up to be a winning year for bonds, there has in fact been a 1:1 score draw over the last two months because yields went up in February, reversing the declines of January. For those who don't follow football (we prefer not to call it soccer), this is when both teams score at least one goal and, when the match ends, they have an equal number of goals.

We have admittedly been selective. Viewed over the last year, the bond market has been delivering for the bears on average in two out of three months. Taking the yield on the US 10-year Treasury, through the previous six months, the bears won 4:2 because there were more months when yields rose. Over the last 12 months, yields rose in eight months, so the score was 8:4 to the bears.

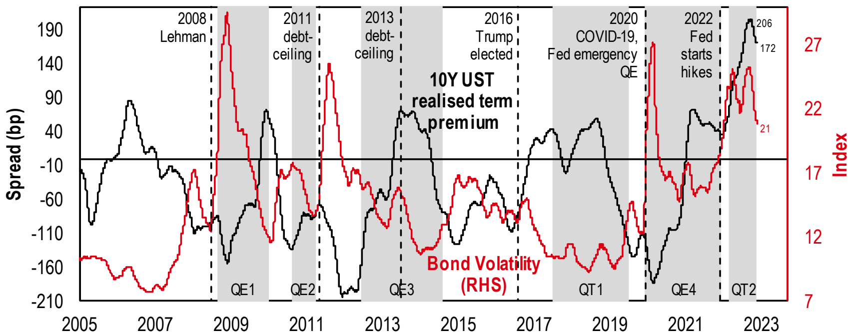
Three questions need answering. What has been driving the latest rise in yields? Is increased volatility symptomatic of a bumpy turning point? Or does the recent rise in yields mean yields will be higher-for-longer?

In answer to the first question, the bullish run for bonds that started last October was anticipating softer data that did not materialise. February data releases confirmed an economy running hot with full employment and stubbornly high inflation. This trumped the view that signs of disinflation would continue, buoyed by easier energy prices and evidence of weakness in the housing market.

Initial conditions made the February sell-off appear quite fierce. At the beginning of the month, when two-year Treasury Note yields were at 4.10%, they were maybe over-interpreting the reduced pace of rate hikes and, flying in the face of Fed guidance, even looking for cuts.

It is likely true that we are nearer to the end of the tightening cycle than the beginning, but central banks don't want the markets to get ahead of themselves. Today it is 4.8%, so the two-year Treasury Note is more consistently priced to the Fed's guidance for the policy rate, as per the December dot plot.

Figure 1. Realised term premium and bond volatility



Source: Bloomberg, HSBC
Note: 3M moving averages. CBOE 20Y+ UST Bond Volatility Index used. Realised term premium is spot 10Y UST minus 1Y lagged 1Y10Y forward UST.

This is a Free to View version of a report with the same title published on 28-Feb-23. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

Disclosures & Disclaimer

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

View HSBC Global Research at:
https://www.research.hsbc.com

To answer the second question, we can see from the chart that higher yields are also associated with increased risk premium. More surprises mean higher bond volatility. This is what happens when economic data beats or misses expectations. But when markets adjust sufficiently, the risk premium may start to dissolve, consistent with yields falling back down.

We take the forward yields as a proxy for consensus expectations, and can measure the extent to which bond markets have been “surprised” by central banks, and their response to the data, with a measure we call the realised term premium. This is what the forwards expected a year ago subtracted from what actually transpired.

Our chart shows a move towards 200bp for the 10-year segment, reflecting how policy has been tightened far more than expected by the market. Recall that at the end of 2021, the Fed’s dot plot was guiding policy rates close to 1.0% in a year’s time. Just over a year later, they are guiding the Fed funds to at least 5.0%. So bond yields rose by about half as much as the policy rate.

Higher bond volatility is associated with the hawkish outcome from central bank policy but it can also be related to geopolitical uncertainty or developments from within the financial markets themselves. Whatever the cause, markets don’t like volatility and tend to respond by requiring compensation in the form of higher yields.

This takes us to the third question, as to whether there is a regime shift afoot, where the peak in rates becomes a plateau. If this is the case, yields will not be returning to the low levels of previous years anytime soon. We would argue that given the 10-year yield is close to 4.0%, it is arguably pricing in a regime shift of sorts. Without getting into the specifics of lower versus higher longer-run rates, our chart at least shows elevated risk premium around the equilibrium.

A simple example will help. Imagine that policy rates averaged approximately 5% for the next five years and then 3.0% for the following five. This is a “hawkish” scenario implying both higher-for-longer rates, and a longer-run equilibrium 50bp above that guided by the 2.50% in the dot plot. In this case, the average for 10-year expected rate would be 4.0%, not far off from where the market is today, calculated by adding together the rate for the two periods and dividing by two.

In essence, the debate in bond markets today is whether to buy and hold short-dated bonds at close to 5%, or go for the longer ones which are almost 4.0%.

Those that think the bear market of 2022 has resumed will nonetheless play it safe and stay in the shorter maturities. Confident in the view that rates will remain at 5%, or even higher, they will not be worried about having to reinvest at lower yields in the future.

What if the peak for rates is close and the rise in bond market volatility is an indication of a bumpy turning point? Bond investors will consider this to be opportunity cost and know it is not a simple case of taking the highest yield. The bond bulls believe rates will be *falling before long*, and prefer the longer maturity, locking in yields at 4%.

Ultimately, bond investors have to be comfortable that the majority of the tightening is in the past, and that market expectations of higher equilibrium policy rates are due to a higher risk premium that will dissolve over time. Chastened after the beating of last year, the bond bulls will anyway take a score draw.

Previous editions of ‘The Major bond letter’

#1. *Eurozone common issuance*
#2. *How to spice it up in a dull market*
#3. *New year, old narrative*
#4. *Beneath the surface*
#5. *The bond market sell-off*
#6. *Treasuries and trees*
#7. *Inflation rationality*
#8. *Lucky number*
#9. *Stuck in the middle*
#10. *Taper and the Hole*
#11. *Every basis point counts*
#12. *Push back*
#13. *Game of chicken*
#14. *Across the pond*
#15. *The most insightful question*
#16. *QT teaser*
#17. *Hikes that won’t stick*
#18. *China-US divergence*
#19. *Warp speed*
#20. *Usefully wrong*
#21. *Second half narrative*
#22. *Curve cacophonia*
#23. *Breathe (in the air)*
#24. *EM reaps rewards*
#25. *The Grizzly*
#26. *Bring it on*
#27. *Funny old game*
#28. *Japan’s curveball*
#29. *The penultimate hike*

Disclosure appendix

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Steven Major, CFA

This document has been issued by the Research Department of HSBC.

HSBC and its affiliates will from time to time sell to and buy from customers the securities/instruments, both equity and debt (including derivatives) of companies covered in HSBC Research on a principal or agency basis or act as a market maker or liquidity provider in the securities/instruments mentioned in this report.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at *www.hsbcnet.com/research*.

Additional disclosures

1. This report is dated as at 28 February 2023.
2. All market data included in this report are dated as at close 24 February 2023, unless a different date and/or a specific time of day is indicated in the report.
3. HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
4. You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

Disclaimer

Issuer of report
The Hongkong and Shanghai Banking Corporation Limited

This document has been issued by The Hongkong and Shanghai Banking Corporation Limited, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither The Hongkong and Shanghai Banking Corporation Limited nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmission of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority.

[1208783]