29 April 2024

The Major bond letter

#48. Triple top

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Global

We are watching the formation of a third peak for yields in the last 18 months. The two previous occasions did not prove to be definitive buying opportunities, so there is quite some trepidation around the current rise in bond yields (fall in prices).

A triple top is a term used to describe a chart pattern of three peaks, at approximately the same level, followed by pullbacks. In technical analysis, to qualify as a signal that there might be a change in market direction, the triple top should occur following a period when there was an uptrend.

The underlying assumption is that the yield peaks form a level of resistance against higher yields, and that if the yield were to fall below previous lows in the pattern, the triple top would be complete. At this point, investors and traders would look for a further decline in yields.

Our chart plots both nominal and real yields at the short end of the US curve. We use the one-year forward rate (1Y1Y) for Treasuries and inflation protected securities (TIPS), the latter capturing the real yield. Forwards help us remove the near-term cyclical noise, which is currently associated with the two-year spot yield, for example, and provide a more stable market estimate of where yields will be one year hence.

The nominal yield (red line) has not quite formed the third peak, but if the trend of recent weeks continues, this might be a triple top in the making. We see that the first peak was just before the regional bank stress in March 2023, and the second in mid-October 2023, coinciding with strong real economy data and a background narrative of a demand-supply mismatch in the Treasury market.

Why does it matter whether the 1Y1Y rate forms a triple top? It's only a chart and, while there may be some psychological importance for the yield levels, surely investors should be more focused on the fundamentals?

Here are four reasons why it is worth watching.

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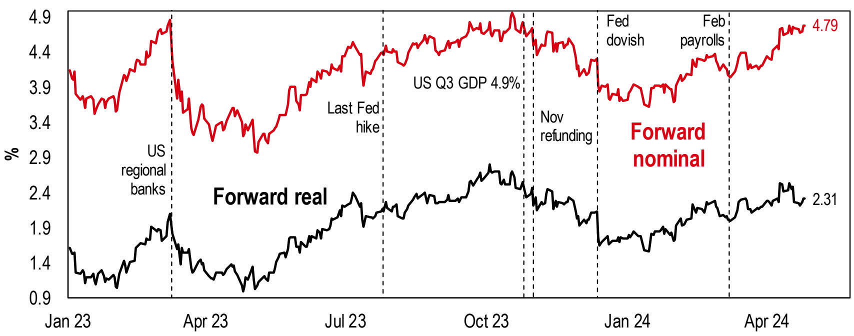
Triple top approaching for 1Y1Y



Source: Bloomberg, HSBC. Note: Real yields are what is left after subtracting inflation. 'Forward real' is the 1Y1Y USD Treasury Inflation Indexed 1Y1Y rate (G0169 1Y1Y BLC2 Curncy). 'Forward nominal' is the 1Y1Y USD Treasury 1Y1Y rate (G0025 1Y1Y BLC2 Curncy).

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First, the 1Y1Y is probably the most important rate for participants in global fixed income, and all the other asset classes that are linked to it. Everyone may watch the 10-year Treasury, which is the go-to benchmark, but its yield is mainly driven by the short rate and the expectations for where it will settle. Because it has a longer maturity, the 10-year will tend to be less sensitive to shifts in short-term rate expectations, and this is reflected in a tighter range over the period covered. But what matters is that the pattern is like the 1Y1Y in our chart.

Second, the real yield (black line) explains a large proportion of the directional shift in the nominal yield, and this suggests that it is not about inflation. Bond yields are where they are because of persistent upside surprises to growth, shown in the real yields. And real yields are high because of a combination of factors that nobody expected: continued fiscal largesse, population growth and technology stock enthusiasm leading the equity market rally. Given that this is all known and presumably factored in, the hurdle to a further upside surprise has presumably been moved higher. The focus should be on the sustainability of the factors that gave us the growth surprise, more than the small upside surprise to inflation.

Third, as everyone will know, the yield curve has refused to steepen! The 2-10 year Treasury yield curve has been inverted for more than two years, frustrating investors who are expecting the curve to normalise. Explaining the inversion is the front-end anchor to the curve. Today's policy rate is more than double the Fed's estimate of longer-run equilibrium, and until policy rates start to decline – as opposed to expectations of rate cuts – it will be difficult for the curve to disinvert and then steepen to a 'normal' shape. There is an alternative argument that long-end yields will lead the steepening but this has historically been unusual and would likely require some sort of policy mistake or loss of credibility in fiscal and/or monetary policy.

Fourth, the direction of the US dollar. Rate differentials support the dollar versus other currencies and therefore have implications for monetary policy elsewhere. An example is the continued rise in dollar/yen since the Bank of Japan tightened policy last month, which might suggest more tightening will come (see *#46. Big in Japan*, 19 March). And an extension of the recent trend would suggest that at some point dollar strength might even have an impact on the Federal Reserve's view of just how tight policy has become.

In summary, we've listed four points why the 1Y1Y yield peak matters. It's a widely used reference rate for fixed income, with the real rate recently the main driver, while being the key to the yield curve normalisation, and an explanation for dollar strength.

Whether we believe in technical analysis or not, we have to respect that a significant level is being approached. We prefer not to include a proposition in the titles of our publications but could easily have made an exception here. Is this a triple top? Imagine if the answer was "maybe not". This would be the view of those participants who think yields could be about to blow through the top of the range, reflecting how everything has changed.

Indeed, bonds are not behaving as they used to, fiscal policy is ultra-loose and, at a time of heightened geopolitical risk, bonds are not receiving the safe haven flows that we might have expected. On the other side of the debate, these yields are not sustainable and for those investors that felt they missed previous opportunities to buy bonds, maybe there is another now.

The move in yields this year has corresponded to the pricing out of rate cuts, from almost seven 25bp increments to less than two today. From investors' perspectives, there is at least some comfort to be drawn from how little easing is now priced in. They will be hoping that the correct interpretation of our chart is the formation of a triple top, thereby signalling that the uptrend in yields is set to reverse.

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