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The Major bond letter

#44. Opportunity Knocks

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Fixed Income - Rates

Global

Steven Major, CFA
Global Head of Fixed Income Research
HSBC Bank Middle East Ltd, DIFC

Continue to sit in the relative safety of the money markets or take the plunge into bonds? That's the big question for bond investors today.

In the talent show *Opportunity Knocks*[1] winners were decided by a public vote, rather than a panel of expert judges. It's similar in the bond market. We have our own views and whilst we can seek the opinions of others, ultimately, it's the aggregate opinion and decisions of bond investors that determines yields.

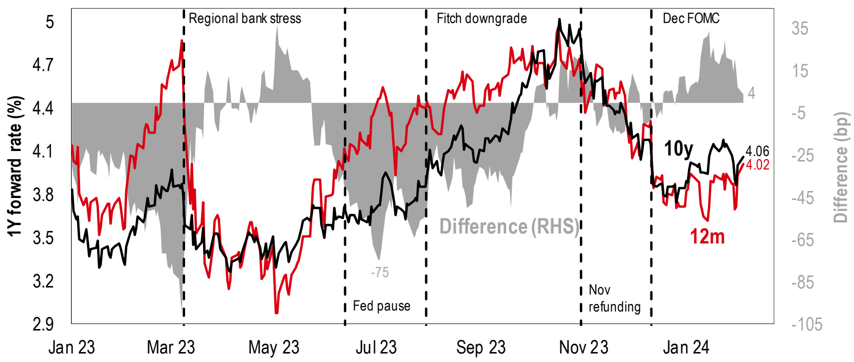
It's a catchy name for a television programme. When used in a sentence, "opportunity knocks" describes the chance to do something that a person wants to do, along with the need to be ready to act when the chance arises. It might be that the opportunity only comes once. It might come again. The thing is, we won't know whether an opportunity has been missed until afterwards.

The bond market provides investors and other market participants the choice between investing in short or long-dated maturities, in this case choosing between buying a 12-month Treasury bill or a 10-year Treasury note. When they commit to one or the other, though, they'll be cognizant that, like in the show, the opportunity might not arise again.

Bond investors know about opportunity cost, the consideration of alternatives foregone, and reinvestment risk, a function of what's likely to be available in terms of yield in one year from now. It sometimes helps to consider the macro backdrop and will require a view on where central bank policy rates are heading.

If rates are going to fall quickly then it would be better to lock in the 10-year rate whilst the opportunity is there. Alternatively, those with a view that rates are on hold (or maybe about to go up) will stay with the bills and take the risk of reinvesting in a year from now.

The opportunity cost challenge one year on



Note: '12 month' and '10-year' represent the 1Y1Y and 1Y10Y US Treasury forward rates, respectively.
Source: Bloomberg, HSBC

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[1] Opportunity Knocks, a British talent show on television and radio

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There is information value in what we would do today compared with what we would have done in the past. And to capture this in a useful way we need to avoid hindsight bias and recall context and rationale behind a decision. Readers of this letter one year ago will recall that many investors chose the bills. They were the “soft landers”, or of the view that inflation was still not beaten, thereby requiring rates to go still higher. Those that chose Treasury notes were more likely to be “hard landers”, anticipating a market event or sharp slowdown in the data to justify significant rate cuts.

We look back and see that, as is often the case in markets, everyone had the chance to be happy with their choice at some point last year. Our chart shows the sharp drop in yields around the time of US regional bank stress (low point 6 April 2023), and then six months later, the yield surge through the period of supply-demand imbalance (peaking 19 October 2023). Then, to complete the circle, the sharp fall in yields through the last two months of the year meant that the year ended pretty much where it started.

Consensus forecasts and forwards tend to move together, so we used one year forward rates for the bills and 10-year notes, allowing us to track market expectations for what these choices would look like. The 2% range for both time series means staying with the same view would have meant everyone had the chance to be right at least once!

Our chart shows that the difference between the two forward yields (right-side axis) puts the 10-year Treasury note on top. Given this didn’t happen much recently, for those who like to go against the market, this favours the 10-year note over the 12-month bill. Just saying.

A few months ago we discussed how momentum and value appeared to be shifting in favour of bonds over bills (see *#39 Momentum, value and opportunity*, 18 September 2023). What’s different today is clarity over the direction of rates. The Fed and ECB have effectively said they are done hiking, leading markets to conclude that the next policy rate move is either unchanged or down (see *#42. Going Binary*, 11 December 2023).

Opportunity Knocks reminds us that it is not what we think that matters, it’s the combined view of everyone else that will drive market values. We are all watching what will happen to the trillions of dollars sitting in bills and money market funds[2], and wondering when this might move up the curve into bonds.

As our chart shows, opportunity came knocking at the door last October when long-end yields were almost touching 5% on concerns over a supply-demand imbalance. It’s this memory that haunts some investors, contributing to their hesitance to extend from bills to bonds.

We recall the *clap-o-meter* from the early studio version of *Opportunity Knocks*. When the audience clapped loudly it was a measure of approval, a form of instant feedback in the days of postal vote. Just a little clap, not so good. Younger readers might regard this as rather quaint but for the time this was high tech.

The consensus view coming into 2024 was this: there’s a lot of bond supply coming (that one again), rate cuts were already priced-in, and this meant yields could still go higher.

What just happened in January? Record supply was absorbed, and markets became more convinced that policy rates are coming down. The *clap-o-meter* suggests bonds might win over bills, but the full vote is not in yet.

[2] Money Market Fund Assets, Investment Company Institute, 1 February 2024

Previous editions of 'The Major bond letter'

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