The Major bond letter

#5. The bond market sell-off

Free to View
Fixed Income - Rates

Global

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

Regular auctions of US Treasuries are normally inconspicuous events, so last week's 7-year issuance will live long in the memory, even serving as a data-point for future references to the 2021 bond market sell-off. Only time will tell whether last week's rout was the start of a shift in the market regime, or whether, as we suspect, it was just another one of those corrections that characterise a highly leveraged market.

An unusually large proportion of the bonds remained in the hands of primary dealers, as opposed to long-term investors, at the 25 February auction, resulting in an immediate rise in yields, and not just in the 7-year segment. 10-year US yields rose some 16bp that day.

Such a large move in the USD21trn Treasury market matters because it is a global benchmark and it provides reference rates for investors in all asset types. Evidence of this came as the ECB began to fret over what rising yields would do to Eurozone financial conditions and the Reserve Bank of Australia doubled down on yield curve control with massive intervention.

So what was the ***root cause*** of the event that caused so much consternation in the bond markets?

The Biden administration's proposed USD1.9trn US fiscal support package is the equivalent of about 10% of GDP, which combined with what has gone before means the Federal government deficit would reach an unprecedented peacetime level. This is not to argue that support isn't warranted to help get through the pandemic, just that the policy response has exacerbated the problem of a bloated debt stock.

Table 1. Global debt continues to grow at a faster rate than GDP

(USDtrn)	Debt	GDP	Multiple
2000	60	33	1.8x
2010	129	60	2.2x
2020	214	78	2.7x
2020-2000	154	45	3.4x

Source: HSBC calculations, IIF debt database for combined DM and EM in USDtrn. Note: total debt across household, corporate and government sectors. 61 country data set used from Q1 2000 to Q4 2020.

Fundamentals matter. Governments may have got to the point where they cannot go on borrowing without there being consequences. Interest rates are low but that does not mean there is a free hit for the borrower, even if some politicians might prefer to think so. Money borrowed today should generate a sufficiently high return versus its cost, otherwise it is unproductive, weighing on future growth. Anyway, it has to be paid back, otherwise future generations will pay for the consumption of this one.

This is a Free-to-View version of a report by the same title published on 04-Mar-21. Please contact your HSBC representative or email AskResearch@hsbc.com for more

We have always stressed the importance of global inter-linkages, feed-back loops and repercussions. During the past two decades the total stock of global debt (see Table 1) has increased three times faster than the economy has grown, so that each unit of new debt is less productive than the previous one in generating growth. Offsetting the increase in debt has been the purchases of bonds by central banks but last week's bond auction suggests there is stress in the system.

Fiscal policy may be dominant but it is inextricably linked with the unconventional monetary policy as central bank bond purchases in the US, Eurozone, Japan, UK and other markets are reinforcing the signal that rates are staying lower-for-longer.

The idea that QE can be open-ended, continuing to support fiscal policy, misses the point that there is a lot going on behind the scenes. Banks are perhaps questioning the economics of the relationship, which sees them receiving the excess reserves created by central banks, and results in them holding such a high proportion of low-yielding assets.

Our focus on how huge fiscal loosening may be hitting capacity constraints is different to some of the ex-post rationalisation about what happened on the 25 February. The mainstream view appears to put this down to enthusiasm for the 'global reflation trade', spurred on by the big moves higher in Australian bond yields. Others may focus on the sheer weight of bond supply against a backdrop of preparation for the inevitable tapering of Fed asset purchases that lies ahead.

Through the first two months of the year US 10-year yields increased 49bp, whilst the three-month bill yield fell 3bp. For all the talk of another taper tantrum, we may have already had something similar but this time it was brought on by the government's aggressive fiscal loosening. Shall we call it a 'fiscal tantrum'?

Whatever the reason, the economy is not going to be helped by higher yields and neither is the aspiration for higher inflation. At the global level we have long wondered how the huge accumulation of debt, only possible thanks to central bank largesse, would play out. The steeper yield curve seems to have resulted in lots of discussions over symptoms but what really matters is the root cause. There is just too much debt.

Previous editions of 'The Major bond letter'

#1. *Eurozone common issuance – a long time coming*

#2. *How to spice it up in a dull market*

#3. *New year, old narrative*

#4. *Beneath the surface*

Disclosure appendix

Analyst Certification

The following analyst(s), economist(s), or strategist(s) who is(are) primarily responsible for this report, including any analyst(s) whose name(s) appear(s) as author of an individual section or sections of the report and any analyst(s) named as the covering analyst(s) of a subsidiary company in a sum-of-the-parts valuation certifies(y) that the opinion(s) on the subject security(ies) or issuer(s), any views or forecasts expressed in the section(s) of which such individual(s) is(are) named as author(s), and any other views or forecasts expressed herein, including any views expressed on the back page of the research report, 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

Important disclosures

Fixed income: Basis for financial analysis

This report is designed for, and should only be utilised by, institutional investors. Furthermore, HSBC believes an investor's decision to make an investment should depend on individual circumstances such as the investor's existing holdings and other considerations.

HSBC believes that investors utilise various disciplines and investment horizons when making investment decisions, which depend largely on individual circumstances such as the investor's existing holdings, risk tolerance and other considerations. Given these differences, HSBC has two principal aims in its fixed income research: 1) to identify long-term investment opportunities based on particular themes or ideas that may affect the future earnings or cash flows of companies in corporate credit and based on country-specific ideas or themes that may affect the performance of these bonds in the case of covered bonds, in both cases on a six-month time horizon; 2) to identify trade ideas on a time horizon of up to four months, relating to specific instruments, which are predominantly derived from relative value considerations or driven by events and which, in the case of credit research, may differ from our long-term opinion on an issuer. Buy or Sell refer to a trade call to buy or sell that given instrument; HSBC has assigned a fundamental recommendation structure, as described below, only for its longer-term investment opportunities.

HSBC believes an investor's decision to buy or sell a bond should depend on individual circumstances such as the investor's existing holdings and other considerations. Different securities firms use a variety of terms as well as different systems to describe their recommendations. Investors should carefully read the definitions of the recommendations used in each research report. In addition, because research reports contain more complete information concerning the analysts' views, investors should carefully read the entire research report and should not infer its contents from the recommendation. In any case, recommendations should not be used or relied on in isolation as investment advice.

HSBC Global Research is not and does not hold itself out to be a Credit Rating Agency as defined under the Hong Kong Securities and Futures Ordinance.

Definitions for fundamental credit and covered bond recommendations

Overweight: For corporate credit, the issuer's fundamental credit profile is expected to improve within the next six months. For covered bonds, the bonds issued in this country are expected to outperform those of the other countries in our coverage over the next six months.

Neutral: For corporate credit, the issuer's fundamental credit profile is expected to remain stable for up to six months. For covered bonds, the bonds issued in this country are expected to perform in line with those of the other countries in our coverage over the next six months.

Underweight: For corporate credit, the issuer's fundamental credit profile is expected to deteriorate within the next six months. For covered bonds, the bonds issued in this country are expected to underperform those of other countries in our coverage over the next six months.

Definitions for trades (Rates & Credit)

Buy and **Sell** refer to a trade call to buy or sell a bond, option on an interest rate swap (**"swaption"**), interest rate cap or floor, inflation cap or floor, or Total Return Swap (**"TRS"**). The buyer/seller of a TRS receives/pays the total return of the underlying instrument or index at the end of the period and pays/receives the funding leg.

Buy protection and **Sell protection** refer to a credit default swap (CDS): the protection buyer/seller is effectively selling/buying the reference entity's credit risk.

Pay and **receive** refer to a trade call to pay or receive the fixed leg of an interest rate swap (IRS), a non-deliverable IRS, the first-named leg of a basis swap, the realised inflation leg of an inflation swap, or a forward rate agreement (FRA). An investor that executes a pay or receive trade is said to be **"paid"** or **"received."**

Payer and **receiver** refer to inflation caps or floors and to swaptions: a payer is an option giving the right but not the obligation to enter a paid position in an interest rate or inflation swap, and a receiver is an option giving the right but not the obligation to enter a received position in an interest rate or inflation swap.

ASW (also asset-swap, Buy on asset swap, Buy on an asset-swapped basis): Buy a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

RASW (also reverse asset-swap, Sell on asset swap, Sell on an asset swapped basis): Sell a bond packaged with a swap that is tailored to eliminate the bond's interest rate risk, effectively transforming the bond to a floating rate instrument whilst preserving the credit exposure to the bond issuer.

Distribution of fundamental credit and covered bond recommendations

As of 02 March 2021, the distribution of all independent fundamental credit recommendations published by HSBC is as follows:

	All Covered issuers		Issuers to whom HSBC has provided Investment Banking in the past 12 months	
	Count	Percentage	Count	Percentage
Overweight	126	27	69	55
Neutral	220	47	89	40
Underweight	127	27	47	37

Source: HSBC

For the purposes of the distribution above the following mapping structure is used: Overweight = Buy, Neutral = Hold and Underweight = Sell. For rating definitions under both models, please see "Definitions for fundamental credit and covered bond recommendations" above.

Distribution of trades

As of 31 December 2020, the distribution of all trades published by HSBC is as follows:

	All Covered instruments		Issuers to whom HSBC has provided Investment Banking in the past 12 months	
Recommendation	Count	Percentage	Count	Percentage
Buy	143	76	90	63
Sell	46	24	21	46

Source: HSBC

For the purposes of the distribution above the following mapping structure is used: Buy/Sell protection/Receive/Buy Receiver/Sell Payer = Buy; and Sell/Buy protection/Pay/Buy Payer/Sell Receiver = Sell. ASW is counted as a buy of the bond and a paid swap, and RASW as a sell of the bond and a received swap. For rating definitions under both models, please see "Definitions for trades (Rates and Credit)" above.

For the distribution of non-independent ratings published by HSBC, please see the disclosure page available at http://www.hsbcnet.com/gbm/financial-regulation/investment-recommendations-disclosures.

Recommendation changes for long-term investment opportunities

To view a list of all the independent fundamental recommendations disseminated by HSBC during the preceding 12-month period, and the location where we publish our quarterly distribution of non-fundamental recommendations, please use the following links to access the disclosure page:

Clients of Global Research and Global Banking and Markets: www.research.hsbc.com/A/Disclosures

Clients of HSBC Private Banking: www.research.privatebank.hsbc.com/Disclosures

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.

Non-U.S. analysts may not be associated persons of HSBC Securities (USA) Inc, and therefore may not be subject to FINRA Rule 2241 or FINRA Rule 2242 restrictions on communications with the subject company, public appearances and trading securities held by the analysts.

Economic sanctions imposed by the EU, the UK, the USA, and certain other jurisdictions generally prohibit transacting or dealing in any debt or equity issued by Russian SSI entities on or after 16 July 2014 (Restricted SSI Securities). Economic sanctions imposed by the USA also generally prohibit US persons from purchasing or selling publicly traded securities issued by companies designated by the US Government as “Communist Chinese military companies” (CMCs) or any securities that are derivative of, or designed to provide investment exposure, to the targeted CMC securities (collectively, Restricted CMC Securities). This report does not constitute advice in relation to any Restricted SSI Securities or Restricted CMC Securities, and as such, this report should not be construed as an inducement to transact in any Restricted SSI Securities or Restricted CMC Securities.

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. HSBC Private Banking clients should contact their Relationship Manager for queries regarding other research reports. In order to find out more about the proprietary models used to produce this report, please contact the authoring analyst.

Additional disclosures

1. This report is dated as at 04 March 2021.
2. All market data included in this report are dated as at close 03 March 2021, 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

Legal entities as at 1 December 2020

'UAE' HSBC Bank Middle East Limited, DIFC; HSBC Bank Middle East Limited, Dubai; 'HK' The Hongkong and Shanghai Banking Corporation Limited, Hong Kong; 'TW' HSBC Securities (Taiwan) Corporation Limited; 'CA' HSBC Securities (Canada) Inc.; 'France' HSBC Continental Europe; 'Spain' HSBC Continental Europe, Sucursal en España; 'Italy' HSBC Continental Europe, Italy; 'Sweden' HSBC Continental Europe Bank, Sweden Filial; 'DE' HSBC Trinkaus & Burkhardt AG, Düsseldorf; 000 HSBC Bank (RR), Moscow; 'IN' HSBC Securities and Capital Markets (India) Private Limited, Mumbai; 'JP' HSBC Securities (Japan) Limited, Tokyo; 'EG' HSBC Securities Egypt SAE, Cairo; 'CN' HSBC Investment Bank Asia Limited, Beijing Representative Office; The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch; The Hongkong and Shanghai Banking Corporation Limited, Seoul Branch; HSBC Securities (South Africa) (Pty) Ltd, Johannesburg; HSBC Bank plc, London, Tel Aviv; 'US' HSBC Securities (USA) Inc, New York; HSBC Yatirim Menkul Degerler AS, Istanbul; HSBC México, SA, Institución de Banca Múltiple, Grupo Financiero HSBC; HSBC Bank Australia Limited; HSBC Bank Argentina SA; HSBC Saudi Arabia Limited; The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR; The Hongkong and Shanghai Banking Corporation Limited, Bangkok Branch; PT Bank HSBC Indonesia; HSBC Qianhai Securities Limited; Banco HSBC S.A.

Issuer of report

The Hongkong and Shanghai Banking Corporation Limited
Level 19, 1 Queen's Road Central
Hong Kong SAR
Telephone: +852 2843 9111
Fax: +852 2801 4138
Website: www.research.hsbc.com

The Hongkong and Shanghai Banking Corporation Limited ("HSBC") has issued this research material. The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority. If it 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.

In the UK, this publication is distributed by HSBC Bank plc for the information of its Clients (as defined in the Rules of FCA) and those of its affiliates only. Nothing herein excludes or restricts any duty or liability to a customer which HSBC Bank plc has under the Financial Services and Markets Act 2000 or under the Rules of FCA and PRA. A recipient who chooses to deal with any person who is not a representative of HSBC Bank plc in the UK will not enjoy the protections afforded by the UK regulatory regime. HSBC Bank plc is regulated by the Financial Conduct Authority and the Prudential Regulation Authority. In Australia, this publication has been distributed by The Hongkong and Shanghai Banking Corporation Limited (ABN 65 117 925 970, AFSL 301737) for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). Where distributed to retail customers, this research is distributed by HSBC Bank Australia Limited (ABN 48 006 434 162, AFSL No. 232595). These respective entities make no representations that the products or services mentioned in this document are available to persons in Australia or are necessarily suitable for any particular person or appropriate in accordance with local law. No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. This publication is distributed in New Zealand by The Hongkong and Shanghai Banking Corporation Limited, New Zealand Branch incorporated in Hong Kong SAR.

In the European Economic Area, this publication has been distributed by HSBC Continental Europe or by such other HSBC affiliate from which the recipient receives relevant services

This material is distributed in Japan by HSBC Securities (Japan) Limited. HSBC Securities (USA) Inc. accepts responsibility for the content of this research report prepared by its non-US foreign affiliate. The information contained herein is under no circumstances to be construed as investment advice and is not tailored to the needs of the recipient. All US persons receiving and/or accessing this report and intending to effect transactions in any security discussed herein should do so with HSBC Securities (USA) Inc. in the United States and not with its non-US foreign affiliate, the issuer of this report. In Korea, this publication is distributed by either The Hongkong and Shanghai Banking Corporation Limited, Seoul Securities Branch ("HBAP SLS") or The Hongkong and Shanghai Banking Corporation Limited, Seoul Branch ("HBAP SEL") for the general information of professional investors specified in Article 9 of the Financial Investment Services and Capital Markets Act ("FSCMA"). This publication is not a prospectus as defined in the FSCMA. It may not be further distributed in whole or in part for any purpose. Both HBAP SLS and HBAP SEL are regulated by the Financial Services Commission and the Financial Supervisory Service of Korea. In Singapore, this publication is distributed by The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch for the general information of institutional investors or other persons specified in Sections 274 and 304 of the Securities and Futures Act (Chapter 289) ("SFA") and accredited investors and other persons in accordance with the conditions specified in Sections 275 and 305 of the SFA. Only Economics or Currencies reports are intended for distribution to a person who is not an Accredited Investor, Expert Investor or Institutional Investor as defined in SFA. The Hongkong and Shanghai Banking Corporation Limited, Singapore Branch accepts legal responsibility for the contents of reports pursuant to Regulation 32C(1)(d) of the Financial Advisers Regulations. This publication is not a prospectus as defined in the SFA. This publication is not a prospectus as defined in the SFA. It may not be further distributed in whole or in part for any purpose. The Hongkong and Shanghai Banking Corporation Limited Singapore Branch is regulated by the Monetary Authority of Singapore. Recipients in Singapore should contact a "Hongkong and Shanghai Banking Corporation Limited, Singapore Branch" representative in respect of any matters arising from, or in connection with this report. Please refer to The Hongkong and Shanghai Banking Corporation Limited Singapore Branch's website at www.business.hsbc.com.sg for contact details. HSBC México, S.A., Institución de Banca Múltiple, Grupo Financiero HSBC is authorized and regulated by Secretaría de Hacienda y Crédito Público and Comisión Nacional Bancaria y de Valores (CNBV).

In Canada, this document has been distributed by HSBC Securities (Canada) Inc. (member IIROC), and/or its affiliates. The information contained herein is under no circumstances to be construed as investment advice in any province or territory of Canada and is not tailored to the needs of the recipient. No securities commission or similar regulatory authority in Canada has reviewed or in any way passed judgment upon these materials, the information contained herein or the merits of the securities described herein, and any representation to the contrary is an offense. In Brazil, this document has been distributed by Banco HSBC S.A. ("HSBC Brazil"), and/or its affiliates. As required by Instruction No. 598/18 of the Securities and Exchange Commission of Brazil (Comissão de Valores Mobiliários), potential conflicts of interest concerning (i) HSBC Brazil and/or its affiliates; and (ii) the analyst(s) responsible for authoring this report are stated on the chart above labelled "HSBC & Analyst Disclosures".

Any recommendations contained in it are intended for the professional investors to whom it is distributed. This material is not and should not be construed as an offer to sell or the solicitation of an offer to purchase or subscribe for any investment. HSBC has based this document on information obtained from sources it believes to be reliable but which it has not independently verified; HSBC makes no guarantee, representation or warranty and accepts no responsibility or liability as to its accuracy or completeness. Expressions of opinion are those of HSBC only and are subject to change without notice. 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 decision and responsibility on whether or not to invest must be taken by the reader. HSBC and its affiliates and/or their officers, directors and employees may have positions in any securities mentioned in this document (or in any related investment) and may from time to time add to or dispose of any such securities (or investment). HSBC and its affiliates may act as market maker or have assumed an underwriting commitment in the securities of any companies discussed in this document (or in related investments), may sell them to or buy them from customers on a principal basis and may also perform or seek to perform banking or underwriting services for or relating to those companies. This material may not be further distributed in whole or in part for any purpose. No consideration has been given to the particular investment objectives, financial situation or particular needs of any recipient. (070905)

If you are an HSBC Private Banking ("PB") customer with approval for receipt of relevant research publications by an applicable HSBC legal entity, you are eligible to receive this publication. To be eligible to receive such publications, you must have agreed to the applicable HSBC entity's terms and conditions ("KRC Terms") for access to the KRC, and the terms and conditions of any other internet banking service offered by that HSBC entity through which you will access research publications using the KRC. Distribution of this publication is the sole responsibility of the HSBC entity with whom you have agreed the KRC Terms.

If you do not meet the aforementioned eligibility requirements please disregard this publication and, if you are a customer of PB, please notify your Relationship Manager. Receipt of research publications is strictly subject to the KRC Terms, which can be found at https://research.privatebank.hsbc.com/ – we draw your attention also to the provisions contained in the Important Notes section therein.

[1166262]