HSBC Global Research

5 January 2022

The Major bond letter

#15. The most insightful question

Free to View
Fixed Income - Rates

Global

Of all the questions we were asked in 2021, the one that struck as most insightful was the following: “what is the least overvalued of these three US assets: 30-year Treasury Bonds, five-year Notes, or the S&P500?”

The short answer is in the yield curve movement of last year. The five-year part of the curve experienced the most significant increase in yields because of the shift in rate expectations, whilst the 30-year hardly moved. Meanwhile, the falling real yields of last year came from rising inflation expectations, and these seem to be associated with the equity market outperformance.

In Q2 2021 the market’s conviction on rate hikes was much lower than today, and this was reflected in the relative valuations of the five- and 30-year segments. Indeed, the situation is now the reverse of back then. Similarly, we recognise the role of real yields in equity valuations but also how they can be distorted, especially after a large move in inflation expectations.

The longer answer comes from a discussion of where the forward yield sits, compared with the expected equilibrium level of rates. The forward is the market’s own implied level of where yields will be at some point in the future. Meanwhile, the view on the equilibrium is more driven by longer-run trends, and for this we can observe Fed guidance on the longer-run dot. The longer-run trend is powerful, one that has been established over many decades. To argue for its reversal is akin to positioning for a major regime shift of sorts, something we have argued against.

When forwards and consensus align on what the central bank is projecting, then the tightening of monetary policy is probably in the price. Money markets imply three rate hikes in 2022 and the same again in 2023. This reflects the median expectation in the Fed’s December dot plot which continued the hawkish surprise that came through from the FOMC in September.

Indeed, markets appear to have become conditioned because, based on the reaction of bonds at the time, September’s surprise was greater than what followed in December. We should also remember that central banks have more tools with which to tighten policy, especially considering the outsized balance sheets, which may mitigate the need for a large number of rate hikes.

What both the central bank projections and forwards tell us is that the level to which rates are likely to increase, implied by the longer-run dot, is still not projected to be higher than in the previous cycle, and in our opinion it is most likely lower. This is the central premise under which the lower-for-longer rates theme is still valid: that each rate cycle peaks at a lower level than the previous one.

For the stock market the valuation references we look at are the price performance of the S&P500 index compared with long bonds – which have a long duration as is assumed for equities – and how this is associated with the move in real yields (see Figure 1). This is one way to integrate the question about the level of overvaluation on the five-year note, 30-year bond, and the S&P 500 index.

This is a Free-to-View version of a report by the same title published on 05-Jan-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

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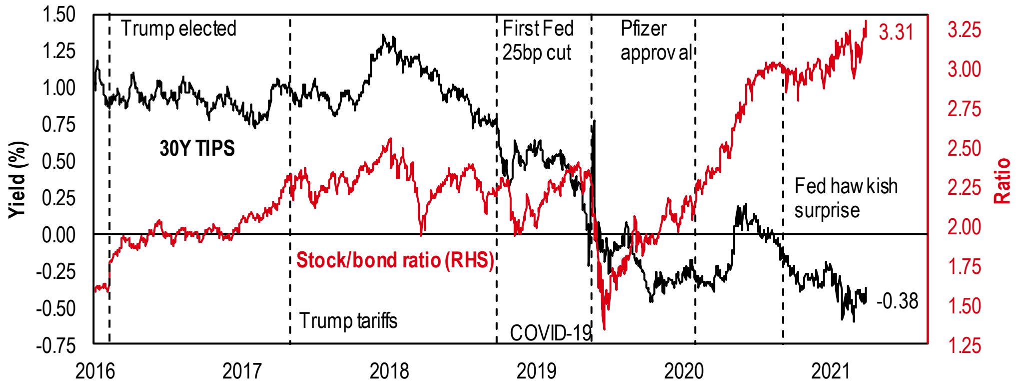
Central banks set nominal policy rates. Likewise, we are referring to nominal yields when we talk about the overwhelming majority of the bond market; the inflation-linked sector is a small proportion of the global bond market. When nominal yields are bound by the central bank's guidance for the policy rate, then rising inflation expectations are the flip side of falling real yields.

Figure 1. Equity outperformance and real yields



Source: HSBC, Bloomberg. Note: Stock/bond ratio calculated as (SPDR S&P 500 ETF Trust / iShares 20+ Year Treasury Bond ETF).

We would even go so far as to say that real yields are a residual, and that, therefore, we should be careful not to infer too much meaning from their recent moves. What if, for example, the rising inflation expectations of 2021 were to move into reverse in 2022? Notice how the falling real yields have been associated with equity market outperformance, shown here as a ratio, where the price on the S&P500 is divided by the equivalent for long bonds (see Figure 1).

We suspect that our answer was not a surprise, and, after all, it's the explanation that matters. Next time maybe we can start with the question and dispense with the presentation, it will save a lot of time!

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
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#14. Across the pond

Disclosure appendix

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