HSBC Global Research

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The Major bond letter

#29. The penultimate hike

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Fixed Income - Rates

Global

The big call everyone has been trying to make over the last few months is: when to buy bonds? Of course we don't have a crystal ball but we are guided by past experience. For example, we think we can look back at 2022 and see the peak for yields was already being established in the final quarter along with a turning point for the US dollar.

Historical data for US bond market returns tells us that the best time to buy bonds is on the penultimate hike. Traders supported by machine learning tools will know what we are referring to. Unencumbered by emotions and biases, without any need for a forecast, the data just gives the facts. At a minimum, it is useful to know this simple rule of thumb: bonds have historically done well after the hike before the last one in a tightening cycle.

Given that US 10-year Treasuries are 72bp below the high point of October 2022, it could be argued that the peak in yields is in the past. We say this having been surprised by the aggressive tightening of last year and having prematurely tried to call the peak a few months before. Meanwhile, for the Eurozone, there seems to have been a double top, with the last peak likely to have been formed in December after the ECB stepped up the hawkish rhetoric. Given the ECB rate hikes are lagging the Fed, we suspect the peak is close.

For bond investors to buy cheaply they need to start doing so near the top of the rate cycle. As our chart shows, there is some learnt behaviour here. On just about every penultimate rate hike in the US, it would have been a good decision to buy bonds, given that the following months saw positive total returns. We have to go back to the Volcker years to find the one exception.

To know when the penultimate rate hike has been reached in advance requires a leap of faith. Investors have to project the policy moves of last year onto the bond market of this year. To help us do this, we might consider how much real yields have already risen, the level of yield curve inversion, or new developments in the leading economic indicators.

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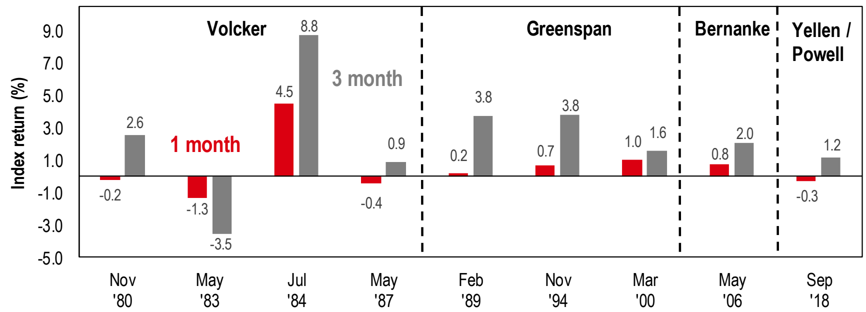
Figure 1. Buying bonds on the penultimate hike



Note: Penultimate hike date shown on x-axis. Bloomberg US Agg Total Return Index calculated from close on penultimate hike date to 1 and 3 months later.
Source: Bloomberg, HSBC

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Real yields are what's left after we adjust for inflation. They moved higher at pace last year, achieving levels well above the previous cycle and the Fed's longer-run equilibrium, which is approximately 50bp given the FOMC's 2.5% longer-run nominal rate and 2% inflation target. Real yields for five year forwards are about 80bp above this level, suggesting that policy is already very restrictive. If monetary policy works with a lag, we are still waiting for it to bite.

Most investors recognise yield curve inversion as an early warning sign of recession and this was already evident in 2022. Perhaps most importantly, the Fed's preferred measure, the front-end forward, also moved into inverted territory on 10 November 2022. This is the difference between the level expected by the market for three-month bill yields in 18 months and the same bill yields today. As a measure of restrictive policy and increasing recession probability, this one appears to matter.

Regarding the data, global purchasing managers' indices seem to be pointing towards a contraction. Indeed, Fed Vice Chair Lael Brainard noted a "significant weakening in the manufacturing sector", and that the impact of last year's aggressive tightening is still to be felt (19 January). The problem is that waiting for the confirmation of an increase in unemployment and reduced wage pressure – anything that warrants a change in policy direction – is likely to take too long.

The bullish bond market performance of the last few months presumably indicates that quite a few investors believe the peak for rates is close. After the dreadful performance of last year there might also be a view that things cannot get worse.

We won't know what the penultimate hike in this cycle is until it has happened. One possibility is that the penultimate Fed hike could have already been delivered in December. This would assume there is going to be a hike at the 1 February FOMC and that it proves to be the last one. Of course, if the rate hikes continue beyond next month, as is widely expected, then we will still be waiting for the penultimate one.

Hypothetically, what if, for some reason, there was no hike in February? In this scenario the penultimate hike would have been the one before the 14 December meeting, which was 2 November 2022.

If this seems a bit far-fetched, note that we just had a conditional pause from the Bank of Canada (25 January) and Chile's central bank kept rates unchanged for two consecutive meetings (26 January). These central banks appear to be ahead in the cycle. It doesn't mean that the next move in rates is down, but neither does it mean the next one is up. The point is that there were no hikes, highlighting the potential for surprises. We will just have to wait and see whether the impact of the previous tightening is starting to have the desired effect.

Markets are discounting mechanisms that assimilate all available information. Waiting for the definitive data release or signal from central banks risks being too late. Recent moves in the bond markets suggest some investors appear to have learnt this. The penultimate rate hike is likely close, if it hasn't occurred already. History suggests this is an important moment.

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