HSBC Global Research

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The Major bond letter

#39. Momentum, value and opportunity

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Fixed Income - Rates

Global

There are three supportive arguments for the battered US Treasury bond market: fading momentum, the restoration of value and opportunity cost. These hold up regardless of one's longer-term fundamental view on interest rates and yields.

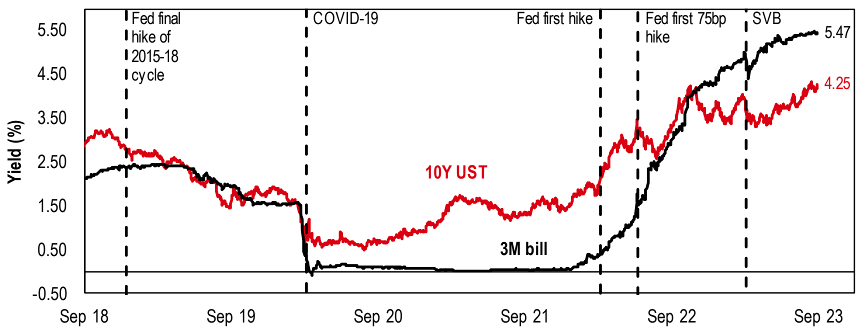
First, momentum behind the bond bear market is slowly grinding to a halt. We can see this from the shift in the trajectory of the monetary policy-sensitive three-month US Treasury bill. Starting with a yield close to zero in January 2022, it followed the US Federal Reserve's hawkish turn, zooming higher at a speed not seen for four decades. Having reached 1.67% in the first six months of 2022, it accelerated to 4.50% by the end of the year.

In 2023, there has been a striking deceleration. The additional 1ppt, to the 5.50% reached in the first week of September, compares with the 4.50ppt surge last year. In monetary policy language, peak hawkishness was more than a year ago. The overwhelming consensus among forecasters is that there will be no hike at the 20 September meeting, and based on the futures market, many think there will be no more Fed hikes this cycle.

Now the challenge for policymakers is to stop the market getting ahead of itself, and positioning for rate cuts. The Fed is well served by the "higher for longer" mantra, for now at least, because it is still waiting for the lagged impact of hikes to come through. Policymakers call this forward guidance. Markets know events or data will decide.

Second, attractive valuations are enough to get bond investors salivating. The absolute value is shown by the real rate, after taking into account inflation, for the 10-year Treasury, which at close to 2.0% sits above the trend for real GDP, projected by the Fed at 1.85%. This is unusual, and means that investors can diversify away from the stock market, and do it with bonds, which traditionally carry less risk.

Figure 1. Treasury bill yields show slowing momentum



Source: Bloomberg, HSBC

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This is unless the trend in economic growth is itself revised higher, justifying a further rise in the real rate. We doubt this will happen. Fiscal largesse drove much of the recent growth, and the impact of the surging debt stock will weigh on future growth through the costs of servicing it.

Relative valuations of Treasuries versus other G7 government bonds look enticing too, a measure of just how far Fed policy has ventured into hawkish territory compared to that of other central banks. And it is the riskier corners of fixed income, credit and emerging market local rates that have been doing well this year. If continuing to hold them is predicated on an eventual turn in the US rate cycle, then it is surely better to hold the bonds that typically benefit the most, US Treasuries.

Third, there is the opportunity cost for those investors hibernating from this bear market, currently tucked up in a bed of Treasury bills – shorter-term government debt that pays interest on maturity. Investors might ask why take the risk of owning a 10-year security that currently yields about 1% less than a Treasury bill? The intuitive view based on the yield difference misses the opportunity cost – the potential benefit foregone by not choosing the other option.

Bonds offer the same fixed coupon over their life, so have so-called higher duration – their price is more sensitive to future interest rate decisions. On the 10-year bond 1bp of yield equals eight cents in price, while on a one-year bill 1bp is equivalent to about one cent. Bills have minimal duration, but high reinvestment risk because today we don't know what the yield on offer will be when they mature.

An example, comparing a 10-year bond yielding 4.25% with a bill yielding 5.25%, shows this. If the yield on the bond were to fall by just 12.5bp, the price gain – when combined with the coupon – would mean the return would be equal to the higher yield on the bill.

Granted, bond prices can both rise and fall, so there is more risk for the investor in owning bonds than bills. But for context, since the start of 2022 – when the Fed turned hawkish – the yield on 10-year Treasuries has risen 266bp. That represents a fall in price equivalent to 21%. Turning this move on its head, with bond yields back to levels last seen in 2007, the opportunity cost of not switching from bills to bonds could be rather high if the move from 2022 starts shifting into reverse.

In summary, momentum and value favour bonds more today than one year ago, providing some solace for investors contemplating the opportunity cost of switching from the predictability of bills.

One does not need to be a perma-bull to buy bonds.

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