



Macro Strategy

# TIPS TIPPING POINT

Oliver Brennan

- **Current leg down in interest rates driven by breakevens, but real yields vulnerable**
- **Threats to growth plus idiosyncratic US factors from Treasury’s cash management to consumption “taxes” set to weigh further**
- **We go long TIPS, looking for real yields to decline further**

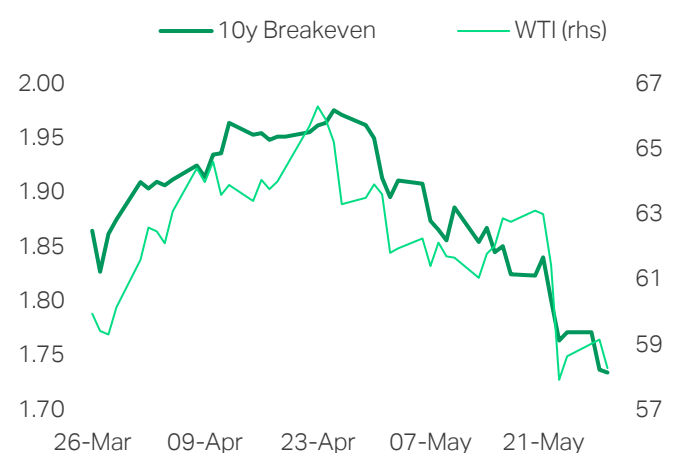
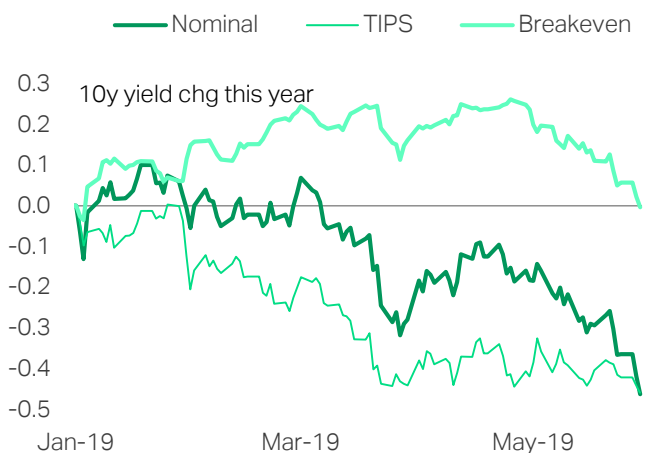
**The anatomy of the yield fall.** One of the best investments this year has been US government bonds, with 10y yields having fallen by 50bp. In the first few months growth downgrades and a declining real yield were largely responsible: year-ahead growth forecasts fell by 30bp in Q1. But in the last month the fall has been more related to inflation, with breakeven rates tracking the drop in the WTI oil price, as Andrea Cicione discussed in this week’s [US Watch](#).

**Pressure on real yields to persist.** For several reasons which we outline below, we reckon real yields will remain under pressure. And owing to a cocktail of factors specific to the US (from Trump’s trade war to the Treasury’s cash position), we expect US real yields to outperform - i.e. they will be lower/fall by more than real yields elsewhere.

**US growth to take another leg down.** Also in this week’s US Watch, Steve Blitz outlined his expectation that GDP growth will average 1% (saar) this quarter and next. We reckon full-year US growth will come in below 2%, which is a good 60bp below the Bloomberg consensus estimate. According to the news agency, only three other institutions are forecasting sub-2% growth this year. The risk of economic disappointments is not confined to the US. We anticipate that full-

**Yields down with real, then breakevens, this year**

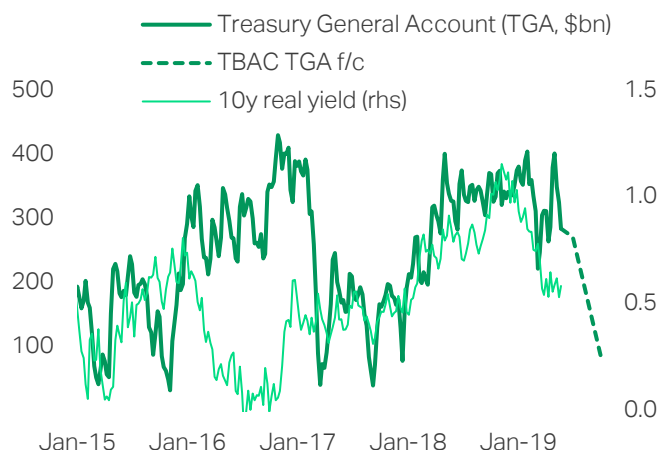
**Breakevens down with oil price**



Source: Bloomberg, TS Lombard

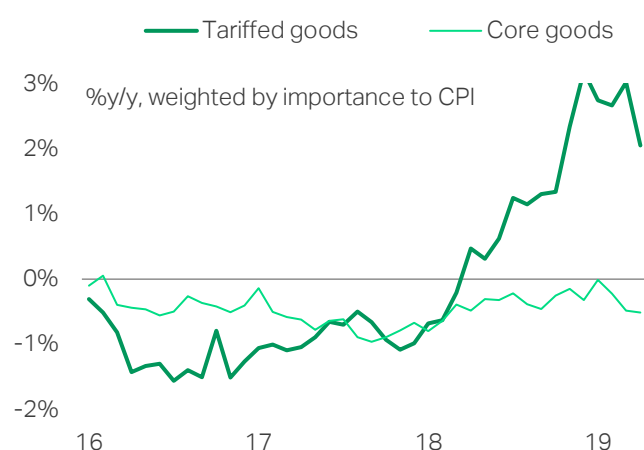
Source: Bloomberg, TS Lombard

## Downside risk to real yields from Treasury



Source: TBAC, Federal Reserve, TS Lombard

## Tariff tax on consumption



Source: TS Lombard, US national sources

year growth in China will be around 6.3% (although the Bloomberg consensus is 6.3%, the “blue-chip” average forecast is 6.4%), and we have catalogued the [anaemic recovery](#) in the euro area in [Europe Watch](#). The recent export-led boost to German and Swedish growth may say more about UK inventory-building than about a resurgence in real demand. And as long as global trade remains subdued (i.e. as long as the US-Sino trade conflict continues to intensify), the risks to world growth will increase.

**US Treasury to take a bite out of real yields.** One reason US real yields are likely to fall further, over and above the faltering economy, is the behaviour of the US Treasury. In [Macro Strategy](#) at the start of this month, when we discussed the gap that was irritating the Fed between fed funds and interest paid on excess reserves, we described how liquidity is set to ease over the summer. That is because Treasury is likely to draw down its cash balance at the Fed as debt ceiling constraints limit new debt issuance. As the rise in its cash balance was behind a tightening of liquidity and an increase in real yields last year, the converse is likely to put downward pressure on real yields.

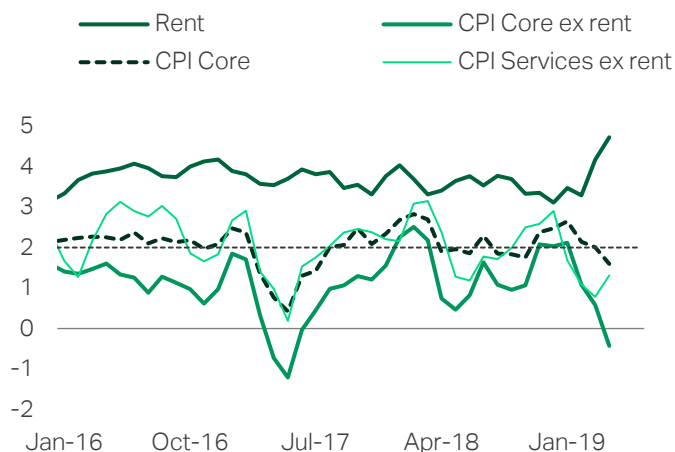
**Real breakeven yield mix will also weigh on real yields.** Although we sidestepped trade war risks in last week’s [Macro Strategy](#) by entering into a sub-sector relative value trade, the risk is unavoidable this time. But for a different reason. In the words of President Trump, China is directly paying the tariffs that Washington is imposing on its exports to the US. But the prices of tariffed goods are rising in the US. A study published this month<sup>1</sup> showed that the import prices of goods affected by tariffs rose in line with the extra duties.

Higher import prices translate into either lower corporate margins or higher consumer prices (or both); evidence suggests it is already feeding through into higher consumer prices – tariffed goods prices have risen by 3% since the start of last year. And this is taking place against a backdrop of weakening personal consumption: the Q1 GDP report showed final sales to domestic purchasers were softer than they have been in more than three years. The rise in tariffed goods inflation is acting as a tax on consumption, and it is likely to raise breakevens to the detriment of real yields.

**Another tax on consumption is unrelated to the trade war: rents.** Despite the Fed’s assertion that ebbing price pressures are transitory, we actually see a strong disinflationary

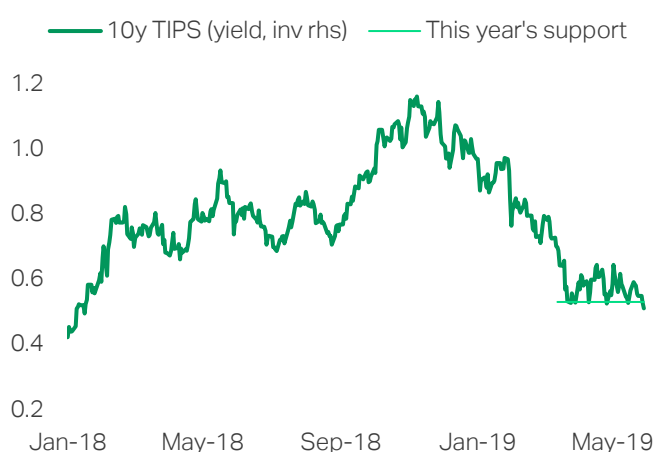
<sup>1</sup> Tariff passthrough at the border and at the store: evidence from US trade policy; [https://scholar.harvard.edu/files/CGNT\\_0.pdf](https://scholar.harvard.edu/files/CGNT_0.pdf)

### Rental tax on consumption



Source: US national sources, TS Lombard

### TIPS yield near tipping point



Source: Bloomberg

trend except for rental costs, which are currently rising at a near-5% rate. Higher rents reduce people's capacity to spend on other things or to save. This is particularly problematic for housing capex, as the 25-34 age group will find it tougher to buy and furnish a first property.

**Real yields are more likely to fall than rise from here.** Even if the trade confrontation were to be resolved tomorrow, we would still project US growth to decline in mid-year and end 2019 below consensus expectations. The longer the trade row drags on, the greater the downside risk to our view.

**Sharp fall in breakevens masking the recent stability of real yields.** As we noted above, the large drop in nominal yields this quarter has been paced by inflation rather than growth. Real yields are currently at the bottom of their recent range; any further fall in yields could tip them into a new, lower range.

**We buy TIPS via the TIP US ETF** (which tracks the performance of the whole TIPS market; note there is no "s" in the ticker) at 114.20 and set an initial stop 2% away, just below 112.

### Portfolio update

The portfolio gained 18bp in the last week, thanks in large part to the relative value healthcare position we initiated last Wednesday, which gained 75bp on the week (and has gained the same again today). We will now watch a stop around 3% below here.

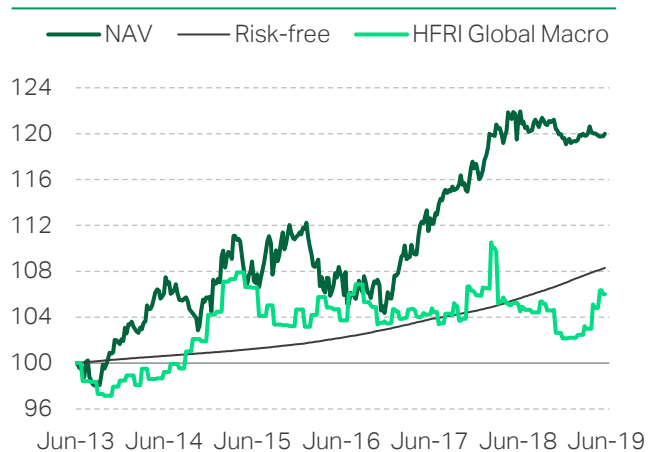
Following Chinese authorities' warnings that "shorting yuan will lead to huge loss" we are more cautious about our short CNH / long EUR, CAD, RUB, KRW position in the portfolio. We reckon that the yuan still has room to decline against its CFETS basket – particularly KRW – but the position has lost 60bp (net) since last week, thanks to RUB weakness. We maintain the position for now, but we will watch carefully for any change in CNY behaviour.

## Current trade recommendations

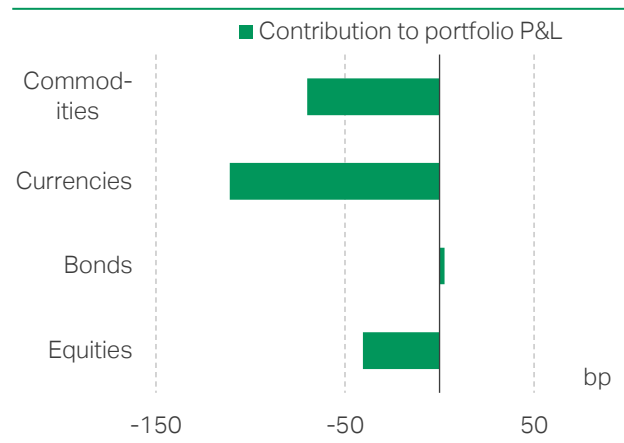
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
<b>Risk hedges</b>							
Long VIX September call spread	10-Apr-19	1.1	1.5	0.4			Equity mkt's discount trade war de-escalation and policy easing; risk of a correction
Long USD/CNH	10-May-19	6.85	6.93	1.21%			Hedge against further trade war escalation
<b>China leading the bounce</b>							
Long EEM vs SPY	24-Apr-19			-4.17%			Foreign (Chinese) growth likely to outperform US
<b>Dollar diversification</b>							
Long AUD/USD 3m call spread	17-Apr-19	0.26%	0.02%	-24bp			Falling vol. stable CNY, China stimulus, iron ore and positioning
Short USD vs EUR, CAD, RUB, KRW	3-Apr-19			-1.8%			Reserve diversification, seasonals and improving China sentiment
<b>Idiosyncratic risk trades</b>							
Long XHE vs IHE	22-May-19	0.517	0.524	1.50%		0.509	Strong sales growth in HC Equip.; pressure on Pharma to lower prices
<b>TIPS near tipping point</b>							
Long TIP US equity	29-May-19	114.20					<b>Downside risk to real yields from Treasury, tariffs and inflation "tax"</b>

**Bold** indicates new trades or changes made this week.

## Model portfolio historical performance



## Performance contribution – last 12 months



## Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	19.98%	6.00%
<b>Annualized Return</b>	<b>3.09%</b>	<b>0.98%</b>
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.98%	-3.48%
YTD	0.37%	3.92%
MTD	0.13%	
Volatility (ann.)	4.33%	3.98%
<b>Sharpe ratio</b>	<b>0.40</b>	<b>-0.08</b>
<b>Sortino ratio</b>	<b>1.29</b>	<b>0.40</b>
Alpha (12m, vs HFRI)	-0.12%	
Beta (12m, vs HFRI)	-0.15	
Corr (12m, vs HFRI)	-0.19	
Corr (12m, vs MSCI World)	-0.14	
Corr (12m, vs JPM GBI)	-0.04	
Max draw down (12m)	-3.02%	-2.78%

## Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	Contrib. (bp)
Long BRL / MXN (17-Oct-18)	55
US 2s10s steepener (07-Nov-18)	48
Short MSCI EM / long MSCI DM (1-Aug-18)	39
Fed Funds Futures Oct19 (23-Jan-19)	29
Long US Consumer Disc. (09-May-18)	27
Worst	Contrib. (bp)
Short Brent / WTI spread (19-Sep-18)	-70
Long EUR / short AUD (03-Oct-18)	-38
Long EM ETF (03-Dec-18)	-36
Short CNY / long JPY (15-Aug-18)	-35
EUR/USD Call Spread (16-May-18)	-31

## Authors



**Oliver Brennan**  
Senior Macro Strategist

## Disclaimer

This report has been issued by Lombard Street Research Financial Services Limited. It should not be considered as an offer or solicitation of an offer to sell, buy, subscribe to or underwrite any securities or any derivative instrument or any other rights pertaining thereto ("financial instruments") or as constituting advice as to the merits of selling, buying, subscribing for, underwriting or otherwise investing in any financial instruments. This report is intended to be viewed by clients of Lombard Street Research Financial Services Limited only. The contents of this report, either in whole or in part, shall not be reproduced, stored in a data retrieval system or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise without written permission of Lombard Street Research Financial Services Limited.

The information and opinions expressed in this report have been compiled from publicly available sources believed to be reliable, but are not intended to be treated as advice or relied upon as fact. Neither Lombard Street Research Financial Services Limited, nor any of its directors, employees or agents accepts liability for and, to the maximum extent permitted by applicable law, shall not be responsible for any loss or damage arising from the use of this report including as a result of decisions made or actions taken in reliance upon or in connection with the information contained in this report. Lombard Street Research Financial Services Limited does not warrant or represent that this report is accurate, complete or reliable and does not provide any assurance whatsoever in relation to the information contained in this report. Any opinions, forecasts or estimates herein constitute a judgement as at the date of this report based on the information available.

There can be no assurance that future results or events will be consistent with any such opinions, forecasts or estimates. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied is made regarding future performance. This information is subject to change without notice, its accuracy is not guaranteed, it may be incomplete or condensed and it may not contain all material information concerning the company and its subsidiaries. The value of any securities or financial instruments or types of securities or financial instruments mentioned in this report can fall as well as rise. Foreign currency denominated securities and financial instruments are subject to fluctuations in exchange rates that may have a positive or adverse effect on the value, price or income of such securities or financial instruments. Certain transactions, including those involving futures, options and other derivative instruments, can give rise to substantial risk and are not suitable for all investors. This report does not have regard to the specific instrument objectives, financial situation and the particular needs of a client. Clients should seek financial advice regarding the appropriateness of investing in any of the types of financial instrument or investment strategies discussed in this report. Lombard Street Research Financial Services Limited may have issued other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Lombard Street Research Financial Services Limited is Authorised and Regulated by the UK Financial Conduct Authority. FCA Firm Reference Number: 502674.

Registered Office: 9 Cloak Lane, London EC4R 2RU. Registered in England No. 6862824