Macro Strategy

WILL UST YIELDS GO NEGATIVE?

Andrea Cicione, Nikol Hearn

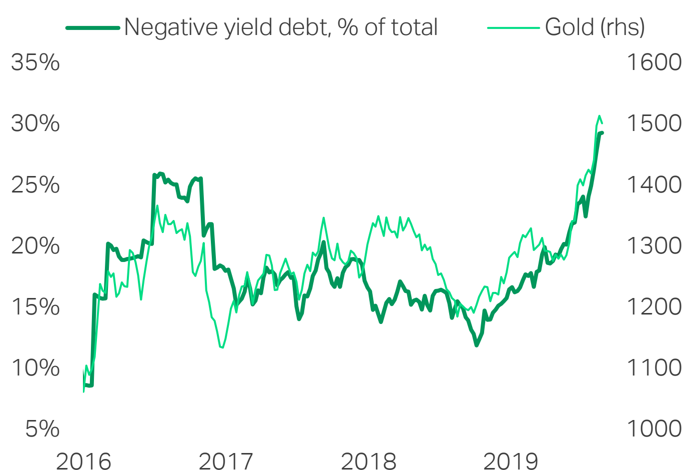
- **UST yields could go negative, but it would probably require a recession**
- **This is unlikely in the near term, but yields will stay under downward pressure**
- **We buy US Transportation vs Aerospace & Defence on US-RoW divergence**

Increasingly negative. The first ever negative-yielding 30-year German Bund was issued today. Given that the share of global investment grade debt that guarantees negative returns to buy-and-hold investors is now in the region of 30% (bottom-left chart), it is perhaps surprising that the latest German issue was poorly received. The real subscription rate (net of retentions by the Buba) fell to 0.43x vs 0.86x at the previous sale, according to Bloomberg.

Can UST yields go negative? With the whole German yield curve now firmly below zero, and even Spanish 10-year yields a whisker away from turning negative, the question everyone's asking is: will UST yields follow suit? Given recent trends, it is entirely possible, and it wouldn't come as a complete shock either. But, for that to happen, the US would probably have to fall into recession – something that we think is very unlikely in the near future.

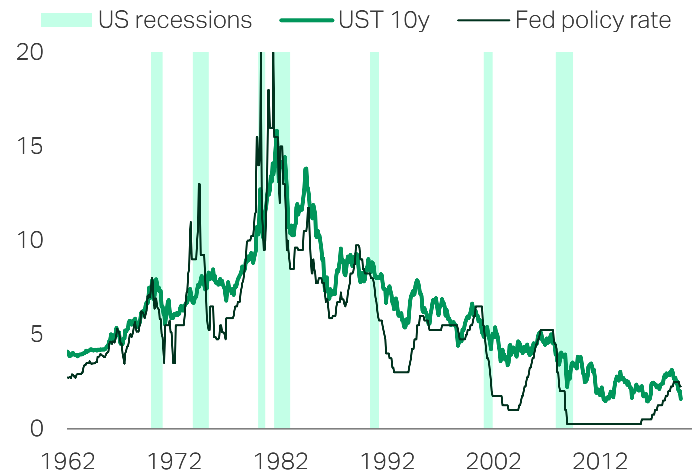
Yields tend to fall by 2 percentage points during recessions and easing cycles. But let's assume, for the sake of argument, that a US recession were to happen in the next few quarters. How far would 10-year yields be likely to fall? We looked at the history of the past six decades and measured the yield decline as the peak-to-trough change during the time the US economy was officially in recession. (Yields often fall before a recession starts, but we are interested in what could happen from here on, so our approach seems sound.) On average, yields have fallen 2.1 percentage points in the past seven recessions, but by only 1.4pp in the last three. Interestingly, yields have also fallen 2.1pp on average during the last nine monetary policy easing cycles (bottom-right chart).

An ever-greater share of negative-yielding debt



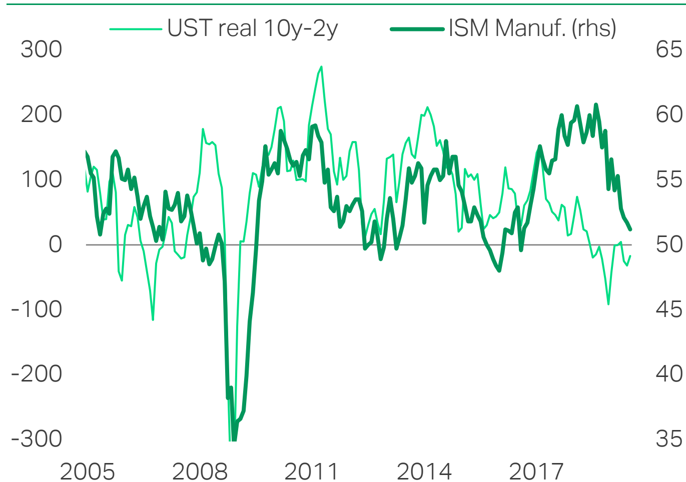
Source: Bloomberg, TS Lombard

Recessions and Fed cuts cause yields to fall



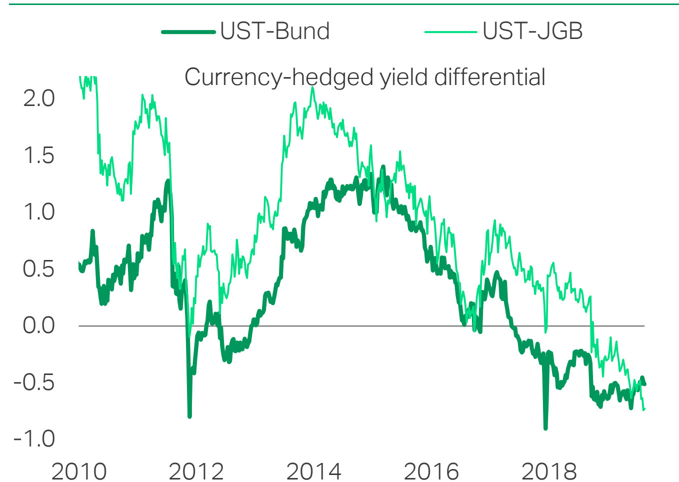
Source: Bloomberg, TS Lombard

Real yield curve fits well with economic cycle



Source: Bloomberg, TS Lombard

UST foreign demand dampened by hedging costs



Source: Bloomberg, TS Lombard

Sub-zero curve. So history suggests that, should a recession induce the Fed to cut rates aggressively, 10-year yields could decline by 200-210bp from here, potentially pushing the entire Treasury curve below zero. But it's also possible to make a compelling counterargument. Suppose, for instance, that we were to learn later on that the recession started in Q3 2019. This would help justify the 50bp drop in 10-year yields that occurred in August. Yields could decline a further 150bp or so, but they would level off at just above zero.

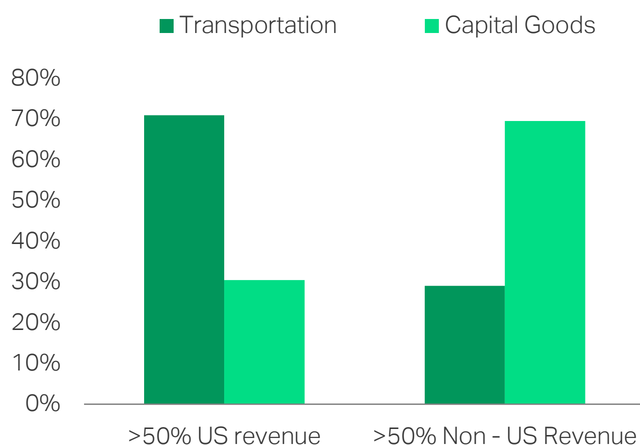
This argument is supported by what's happened to the real yield curve so far. While most investors focus on the nominal curve, it is the difference between 2-year and 10-year real yields that makes a better fit with the economic cycle. What's interesting in the top-left chart is the divergence between the UST real curve and the ISM manufacturing index since mid-2017. A number of factors could explain this, including large swings in inflation (affecting 2-year real yields more) and Fed QT. At any rate, the ISM has now virtually "caught down" with the real curve.

Inversion before recession. If the US economy were to slide into recession, the ISM would almost certainly fall below 50. However, absent a plunge on the same scale as 2008, most of the curve inversion that typically predates a recession has already taken place. This suggests that even if the Fed were to cut rates to just above zero, it wouldn't necessarily mean that 10-year yields would have to be even lower. In fact, by the time the FOMC has finished easing policy, the bond market may have already started to price in a recovery, the curve may have re-steepened and the 10-year nominal yield may have escaped falling below zero.

As a final twist in the plot, let's consider overseas demand for US Treasuries. We've pointed out numerous times in the past how foreign investors' appetite has been fading despite the yield advantage of USD rates vs other DMs. As the top-right chart shows, 10-year USTs have been unappealing to EUR and JPY investors because the cost of hedging their currency exposure has exceeded the pick-up in yield over their domestic markets. However, in a scenario where dollar rates fell significantly, this would change dramatically.

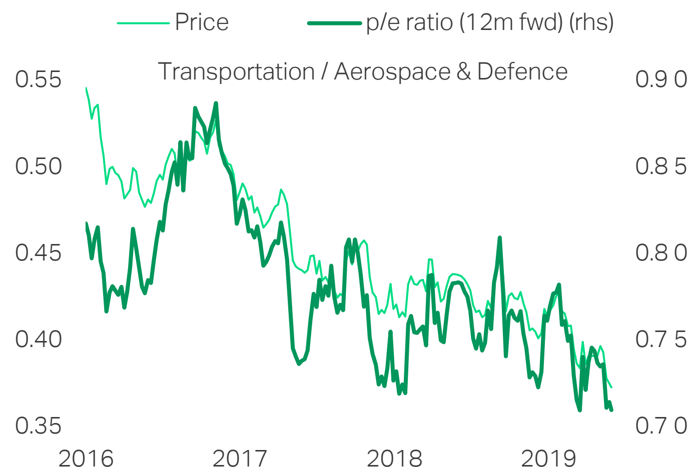
Differential erosion. If the Fed were to cut rates by 100bp, the current 50bp negative carry for a EUR-based investor buying 10-year USTs on a hedged basis would swing to positive 50bp. This would prompt capital flows from the euro area to the US; being hedged, they would be dollar-neutral, but the additional demand for UST would lead to an erosion of the USD-EUR spread. If the whole 50bp yield pick-up were to be arbitraged away, UST yields could decline by another 50bp (more if the Fed cut by more than 100bp). ECB QE2 could amplify this trend.

US Transportation very domestically-focused



Source: Bloomberg, TS Lombard

Transportation much cheaper than Defence



Source: Bloomberg, TS Lombard

In sum, it is possible to construct a compelling case for negative UST 10-year yields, but only under the assumption of a US recession and an aggressive policy response by the Federal Reserve. This is not what we expect and therefore regard this scenario as unlikely in the near term. Nonetheless, the point above about UST yields stands: the more USD rates decline, the more yields will come under downward pressure. As long as the monetary policy easing cycle continues, this is likely to keep US yields from rising materially.

We add another trade to the theme of US growth outstripping the RoW

We have written how weakness in US new goods orders reflects sagging world trade. EU data releases have further darkened the global outlook, with confirmation that Germany's economy, the EU's largest, shrank in Q2. We have also highlighted the extent to which the rest of the world is slowing more abruptly than the US.

We have previously expressed this view as long US Communications vs Tech – the former sector supported by a higher proportion of US-generated earnings, the latter more dependent on revenue streams from the rest of the world. We explored the theme further in a recent US Watch and found a way to exploit it that incorporates an additional macro element.

This week we go long US Transportation and short US Aerospace & Defence. With momentum in the global economy lagging that in the US, we believe Aerospace & Defence will be a relative loser as it is very dependent on non-US earnings. China is a particularly important market. Earnings growth has been strong in the past few years, but we doubt this can be sustained in the current global trade climate. Valuations are also expensive at 21.6x forward earnings.

Conversely, US Transportation is leveraged to the US domestic economy. The sector encompasses freight as well as last-mile delivery. Ahead of the potential increase in tariffs on Chinese imports later this year, not to mention the year-end holidays, we expect significant stockpiling in coming months, which will be positive for freight. At the same time, relatively buoyant consumer spending remains a tailwind for last-mile delivery companies.

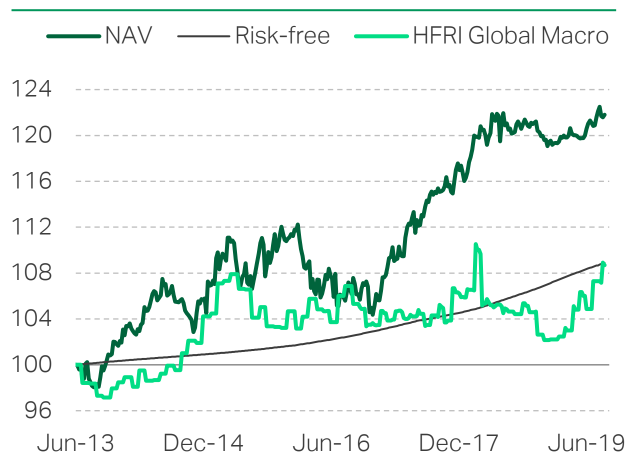
We therefore buy the IYT ETF (iShares Transportation Average) and sell the ITA ETF (iShares U.S. Aerospace & Defence). Transportation's p/e is 13.3x forward earnings (2.7 points below the 10-year average). The differential with Aerospace's 21.6x valuation provides a good margin of safety for the trade.

Current trade recommendations

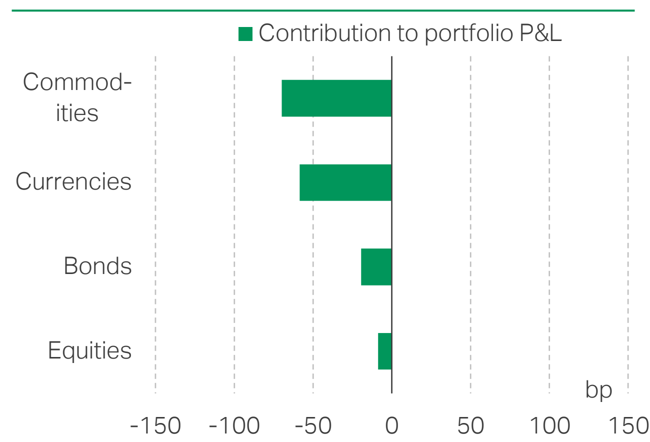
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
French recovery and CD demand							
Long CAC vs DAX	17-Jul-19	0.4515	0.4606	1.97%			French domestic demand and consumption growth vs subdued German growth
Idiosyncratic risk trades							
Long XHE vs IHE	22-May-19	0.517	0.569	10.21%		0.555	Strong sales growth in HC Equip.; pressure on Pharma to lower prices
Long VOX vs VGT	7-Aug-19	0.417	0.404	-3.29%			Domestic US sales and earnings outpacing foreign
Long IYT vs ITA	21-Aug-19	0.837					Internal US trade volume tailwinds and external US trade volume headwinds
Long FFF0 / short FFF1	31-Jul-19	-35.5bp	-44.5bp	-9bp			This cycle is insurance cuts, further easing won't be needed next year
Intervention tension							
Long EUR/CHF 20-Sep call fly	14-Aug-19	32bp	41bp	9bp			SNB currency policy becoming more interventionist
Long USD/CNH	14-Aug-19	7.035	7.069	0.5%			Hedge against global risk appetite taking another leg lower

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

Model portfolio historical performance



Performance contribution – last 12 months



Model portfolio metrics since inception

	Portfolio	HFRI Global Macro
Since Inception return	21.79%	8.69%
Annualized Return	**3.22%**	**1.35%**
2016	-4.89%	0.14%
2017	9.67%	2.47%
2018	2.98%	-3.48%
YTD	1.88%	6.56%
MTD	-0.41%	
Volatility (ann.)	4.26%	4.02%
Sharpe ratio	**0.42**	**0.00**
Sortino ratio	**1.36**	**0.56**
Alpha (12m, vs HFRI)	-0.24%	
Beta (12m, vs HFRI)	0.02	
Corr (12m, vs HFRI)	0.02	
Corr (12m,vs MSCI World)	-0.04	
Corr (12m, vs JPM GBI)	-0.21	
Max draw down (12m)	-2.52%	-2.78%

* Calculated using excess returns & monthly volatility

Best and worst trades – last 12 months

Best and worst performing trades of last 12 months	
Best	**Contrib. (bp)**
Long Healthcare Equipment/short Pharma (22-May-19)	146
Long BRL / MXN (17-Oct-18)	55
US 2s10s steepener (07-Nov-18)	48
Fed Funds Futures Oct19 (23-Jan-19)	29
Long US TIPS (29-May-2019)	29
Worst	**Contrib. (bp)**
Short Brent /WTI spread (19-Sep-18)	-70
Long EUR / short AUD (03-Oct-18)	-38
Long EM / Short US (24-Apr-19)	-37
Long EM ETF (03-Dec-18)	-36
Long Comms/short Tech (07-Aug-2019)	-23

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