Macro Strategy

TIPS TIPPING POINT

Oliver Brennan

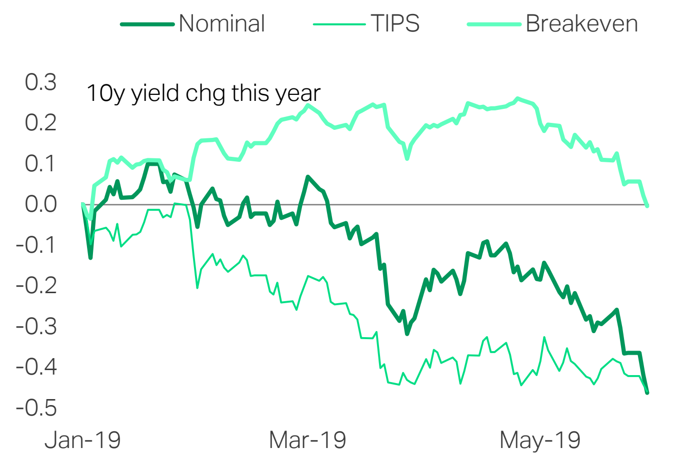
- **Current leg down in interest rates driven by breakevens, but real yields vulnerable**
- **Threats to growth plus idiosyncratic US factors from Treasury's cash management to consumption "taxes" set to weigh further**
- **We go long TIPS, looking for real yields to decline further**

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.

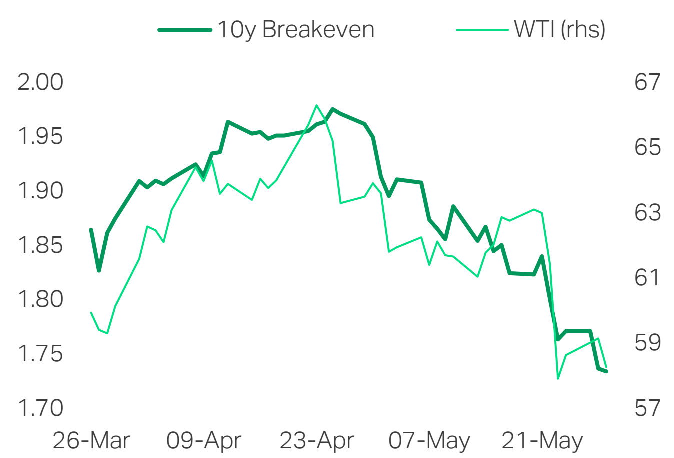
US growth to take another leg down. Also in this week's US Watch, Steve Blitz outlined his expectation that GDP growth will average 1% (saar) this quarter and next. We reckon full-year US growth will come in below 2%, which is a good 60bp below the Bloomberg consensus estimate. According to the news 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



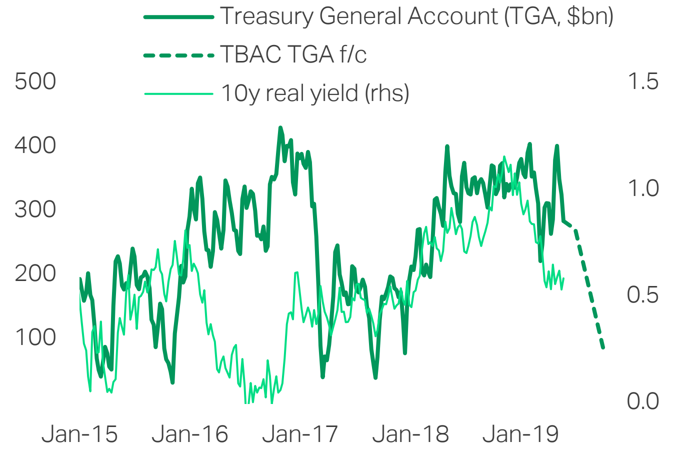
Source: Bloomberg, TS Lombard

Breakevens down with oil price



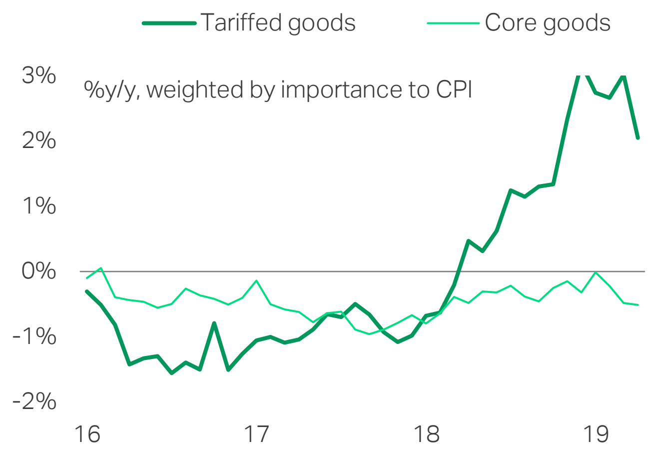
Source: Bloomberg, TS Lombard

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.

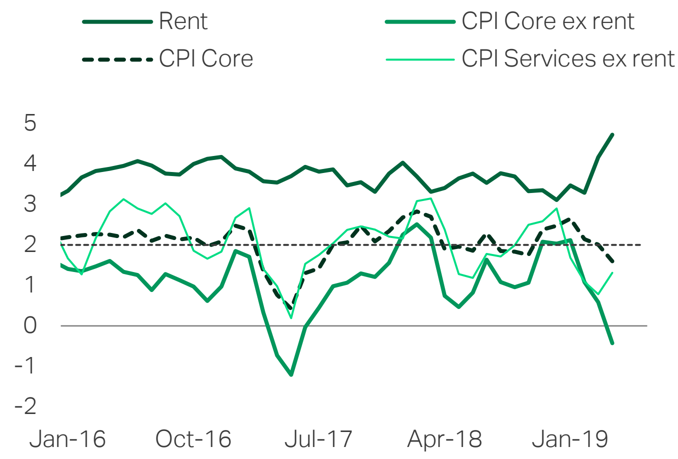
Real breakeven yield mix will also weigh on real yields. Although we sidestepped trade war risks in last week's Macro Strategy by entering into a sub-sector relative value trade, the risk is unavoidable this time. But for a different reason. In the words of President Trump, China is directly paying the 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[1] 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

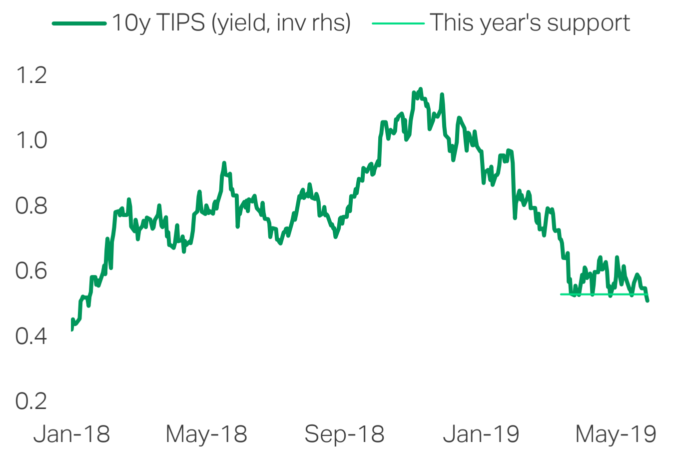
[1] Tariff passthrough at the border and at the store: evidence from US trade policy; https://scholar.harvard.edu/files/CGNT_0.pdf

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.

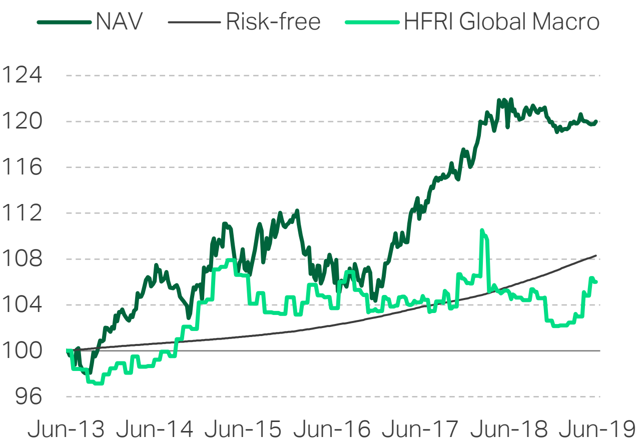
Following Chinese authorities' warnings that "shorting yuan will lead to huge loss" we are more cautious about our short CNH / long EUR, CAD, RUB, KRW position in the portfolio. We reckon that the yuan still has room to decline against its CFETS basket – particularly KRW – but the position has lost 60bp (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

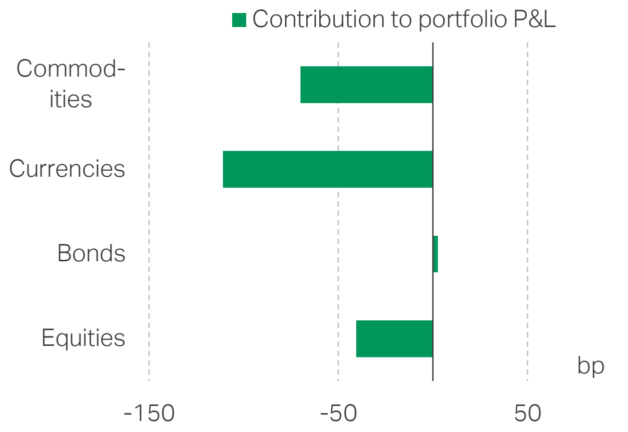
Theme / Trade	Date opened	Entry level	Last	P&L	Target	Stop	Original rationale / comment
Risk hedges							
Long VIX September call spread	10-Apr-19	1.1	1.5	0.4			Equity mkts discount trade war de-escalation and policy easing; risk of a correction
Long USD/CNH	10-May-19	6.85	6.93	1.21%			Hedge against further trade war escalation
China leading the bounce							
Long EEM vs SPY	24-Apr-19			-4.17%			Foreign (Chinese) growth likely to outperform US
Dollar diversification							
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
Idiosyncratic risk trades							
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
TIPS near tipping point							
Long TIP US equity	**29-May-19**	**114.20**					**Downside risk to real yields from Treasury, tariffs and inflation "tax"**

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%
Annualized Return	**3.09%**	**0.98%**
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%
Sharpe ratio	**0.40**	**-0.08**
Sortino ratio	**1.29**	**0.40**
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 drawdown (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

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