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THEMATIC

In this report:

Yields to see gradual rise, uptrend still intact

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Yields to see gradual rise, uptrend still intact

We expect the UST10 yields to rise gradually and will not witness the same velocity of movement that was initially envisaged at the start of the year had there been real inflation fear.

Hence, we have taken a slightly easy tone with respect to the inflation outlook. The current rise in inflation is more of transitory although we maintain the reflationary tagline. And our view is also that the market could be over-reacting to the spread of Covid-19's Delta variant and the effectiveness of the vaccines. This is reflected by the markets suddenly seem to price in for a lower neutral policy rate.

We now expect the UST10 yields to touch 1.80% by year-end from our forecast of 2.00% at the start of 2021. Although lower than the earlier projection, the trend remains upwards.

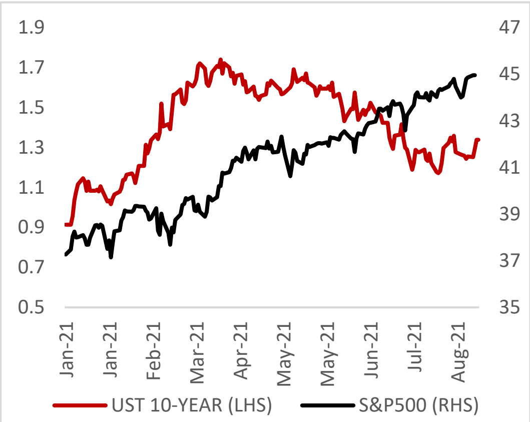
And the lingering question is whether the expected rise in yields, even if less severe than initially expected, will slow down the rise in equity markets. And what happens if the UST10 yields reach our initial projection of 2.00%? With a sharp upward adjustment of 60–70 basis points to take place over the coming months, this will weigh on the equity markets as investors will flock into safe assets.

- The 10-year US Treasury yields (UST10), which act as a key reference point for global assets around the world, fell to 1.18% earlier in August following a sharp rise of debt prices. It happened despite the US economy recovering strongly and growing signs that the US Fed is on the edge of rolling back its stimulus programme, which typically should send yields rising (Chart 1).

Chart 1: UST 10-Year & MGS 10-Year

Source: Bloomberg/AmBank Research

Chart 2: UST 10-Year & S&P 500 ('00)



Source: Bloomberg/AmBank Research

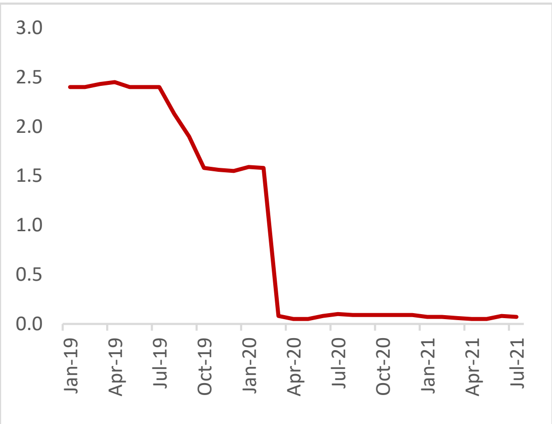
- The trajectory of the UST10 plays an important role for global investors in the fixed income market and is crucial for the future of stock rallies in the US and elsewhere (Chart 2). There is now renewed focus on the outlook of the UST10 after a rally during the summer in the US$22 trillion US government bond market blindsided much of Wall Street.

- Many, including us, were forced to revisit our earlier prediction that the UST10 yields would reach 2.00% by the year-end. This is despite the yields rebounding from a low of 1.18% to 1.34% on 25 August (Chart 1).

- While the data may have lost some momentum, it is hardly a reason for rates to be where they are now. Current levels are more in line with a dimmer economic recovery. And it would in turn justify a much more limited central bank tightening.

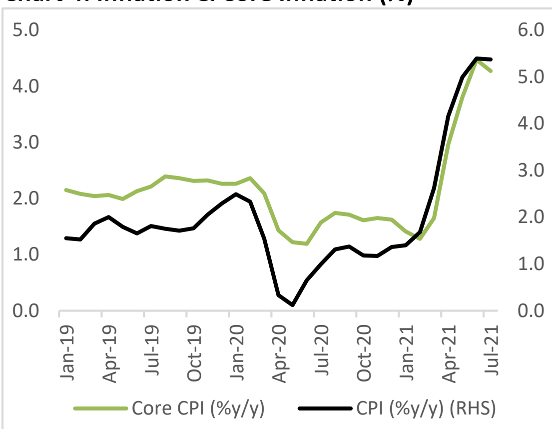
- We found from our research and observation that the yields are expected to rise gradually and not sharply. This means the upwards trend on the yields will not witness the same velocity of movement that we would expect had there been real inflation fear (Chart 4). Hence, we are taking a slightly easy tone with respect to the inflation outlook, expecting the current rise to be transitory. This is despite the uncertainties of a big "if" of inflation numbers rising steadily and the Fed's failure to manage that effectively (Chart 3).

Chart 3: Effective Fed Funds Rate (% y/y)



Source: CEIC/AmBank Research

Chart 4: Inflation & Core Inflation (%)



Source: CEIC/AmBank Research

- Besides, we are of the view that the US Fed's willingness to tighten monetary policy should also help keep a lid on inflation expectations Inflation is the focus of bond investors since it cuts into the income streams that the assets provide. This would mean a more subdued price growth in the future which should help ease the longer term pressure on Treasuries if the Fed is to experience higher inflation.

- Furthermore, the market could be over-reacting to the spread of Covid-19's Delta variant and the effectiveness of vaccines although generally, the vaccines are still being viewed as highly efficacious against the variant. There are some concerns that the economic recovery could lose some steam as it plays out in the economic data.

- And also the markets seem to be pricing in a lower neutral policy rate which we find rather out of place. If the view is that the Fed is hiking rates, we expect this to happen in 2023. Policy rates will potentially reach pre-pandemic levels (when they were at 1.25%), then this is an exaggeration. And so we maintain our reflation tagline, especially when the market gets more comfortable with the Delta variant.

- Hence, we envisage the US Treasuries to hover around the current levels for a brief period. As talk of tapering starts to intensify between the period of August and December, both the front and the back ends of the yields could start moving higher. Investors' positioning is now close to neutral in government bonds.

- With economic surprises emerging, it has opened the door for a slower rise in the UST10 yields as opposed to the earlier forecast. We now foresee the UST10 yields touching 1.80% by year-end, a level that appears to be comfortable for us. But the new level is lower than our previous projection of 2.00% at the start of the year.

- Meanwhile, the lingering question is whether the expected rise in yields, even if less severe than initially expected, will slow down the rise of equity markets. As we know, stocks are generally sensitive to the level of bond yields. With the outlook of lower yields, it should make the potential equity returns more attractive.

- On the other hand, if our initial projection of 2.00% materializes, there are strong possibilities it could cause some volatility in the equity markets. It is not just how much the rise is but also how fast the yields rise. Should that happen in a short period of just a few months, then it could disrupt the equity markets.

- Besides the incoming economic data, the other emphasis is on the timeline towards tapering the Fed's bond purchases. The US infrastructure spending package is another catalyst to lift yields in the near future.

- With yields expected to rise to around 1.80% towards the rest of the year, this could dampen the equity markets. Investors will be expected to flock back to safe assets. Hence, there is a need to focus on this association between UST10 yields and equity markets. For the UST10 to reach the 2.00% level from where it is now, it needs a sharp upwards adjustment of about 60–70 basis points over the coming months.

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