



Macro Strategy Update

REAL YIELDS BOTTOMING

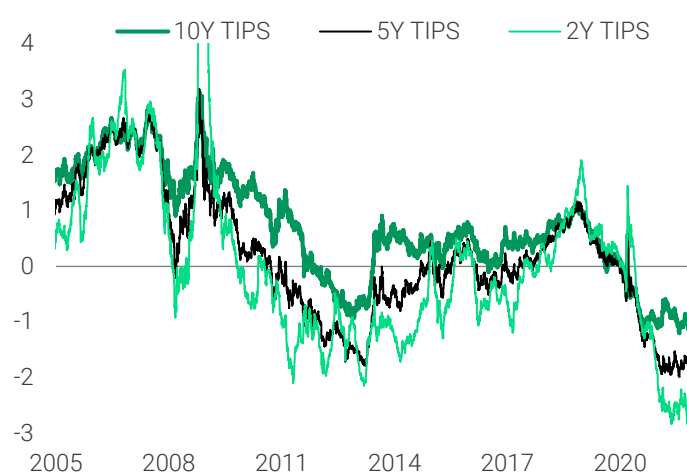
Andrea Cicione / Skylar Montgomery Koning

- Receding inflationary pressures will reduce TIPS demand
- Fed hikes = rising real yields
- Real yields are structurally low; we go short TIPS

Building inflationary pressures have driven Treasury yields higher across the curve, forcing demand for TIPS. The October US CPI print was the catalyst for the most recent upward spurt of UST yield momentum, as the above consensus print and accompanying report confirmed broadening inflation pressures. The knock-on effect of elevated inflation fears is increased demand for Treasury Inflation Protected Securities (TIPS); according to Bloomberg data, TIPS ETFs have seen ~\$60bn of inflows over the past year and ~\$15bn in the past three months. Correspondingly, real yields have recently reached all-time lows across the curve. At the same time, breakevens have been largely rising since mid-September, in line with very elevated energy prices. The combined moves have put breakevens across the curve at record highs. We do not think this dispersion can be sustained.

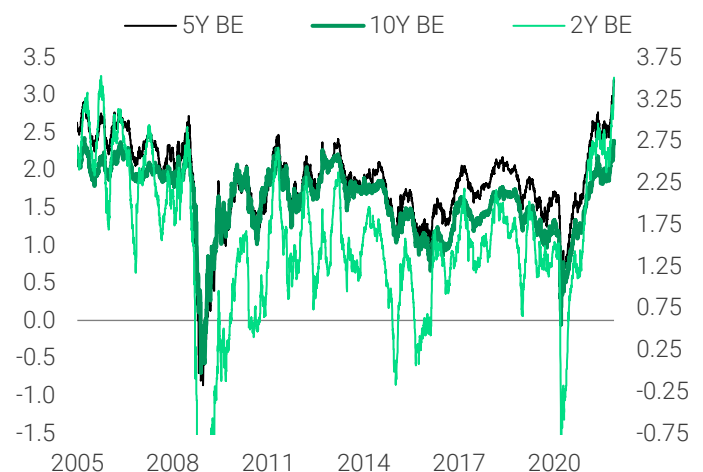
Inflation fears should abate in 2022. Our expectation is that the current inflation episode will fade, since it is mainly about prices reflecting supply-demand imbalances than an inflation process. We also expect this development to be aided by strong deflationary impulses from China, peaking commodity prices and lowered US import prices through a stronger dollar. As inflation data normalize in 2022, there should be less buying pressure on TIPS. As regards supply-demand dynamics in general, we also note that while Fed tapering removes an explicit demand for UST, on the supply side of the equation the demand side is normalizing, too. With the TGA

TIPS at the lows



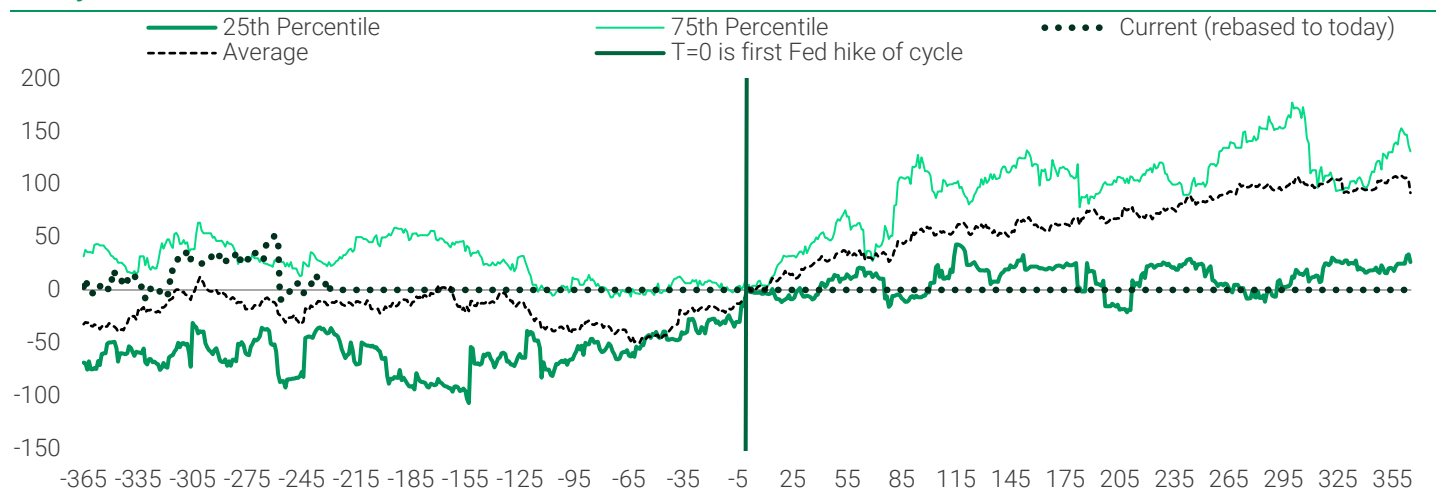
Sources: TS Lombard, Bloomberg.

Breakevens at the highs



Sources: TS Lombard, Bloomberg.

Real yields tend to rise when the Fed hikes



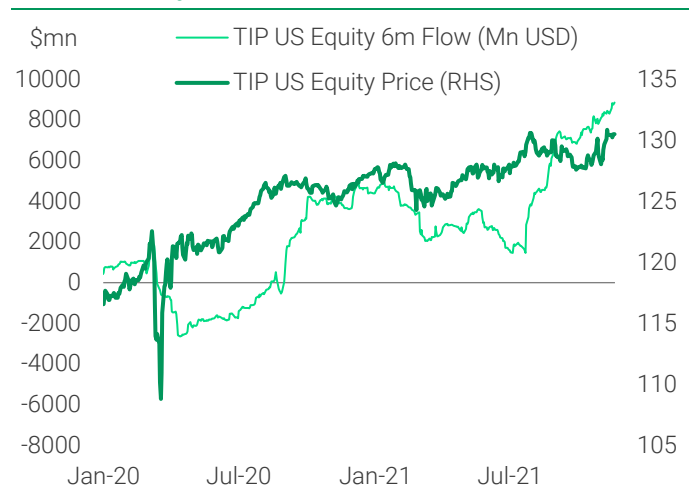
Sources: TS Lombard, Bloomberg.

drawn down to levels commensurate with pre-pandemic norms (\$259bn) but further large fiscal expansion unlikely (above and beyond what is already expected by the market, e.g., Biden's infrastructure spend plan), issuance should stabilize. All in all, this likely means that nominals have limited further upward momentum, but real yields can still rise as breakevens fall.

Real yields rise when the Fed hikes. The idea that the Fed may have to hike to fight inflationary pressures, combined with recent robust employment data, has brought forward expectations for Fed tightening. We assume that in the short term, the current employment and inflation trends will not radically reverse and the Fed will be forced to accelerate the taper pace in December and hike in June 2022. The past 10 Fed hiking cycles (since 1970 – see top chart on this page) show that real yields tend to rise into the first hike (T=0, black vertical line), with the move gaining momentum as the first hike occurs. Real yields are on average ~90bp higher a year after lift-off.

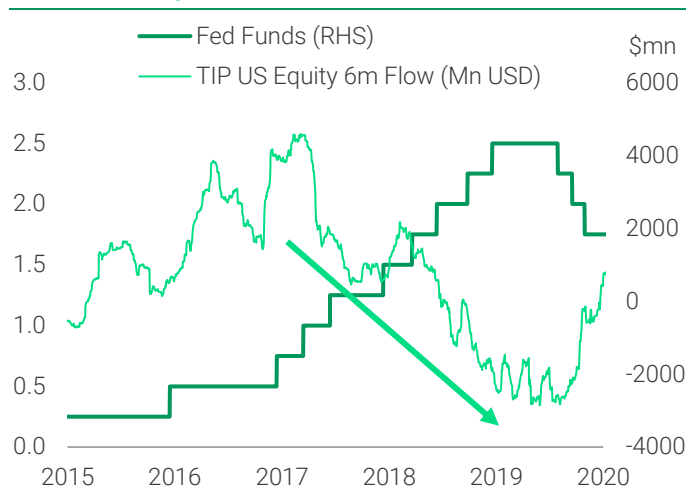
Fed hikes saw TIP US ETF outflows last cycle. Our analysis suggests that the TIP US ETF may see outflows as the Fed moves towards hiking. Given limited data availability we have only one full cycle of comparison, but we find the scale of the flows compelling. Specifically, the TIPS US ETF saw rolling 6m outflows go as low as ~\$2.9bn following the last hiking cycle (see chart below right). This time around, 6m flows at record levels of ~\$9.1bn look particularly vulnerable.

TIP US Equity 6m inflows at all-time high



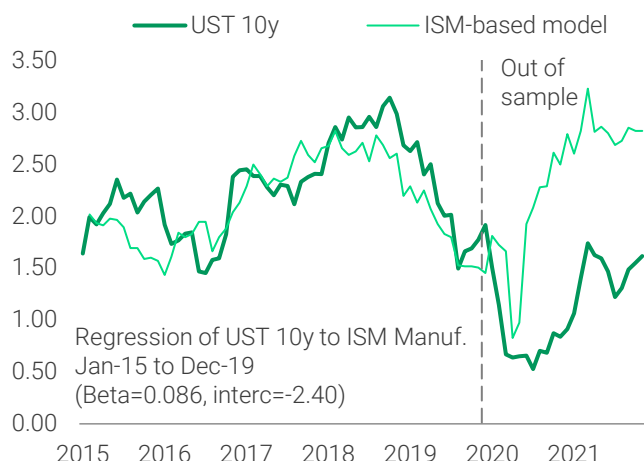
Sources: TS Lombard, Bloomberg.

TIP US Equity outflows follow Fed hikes



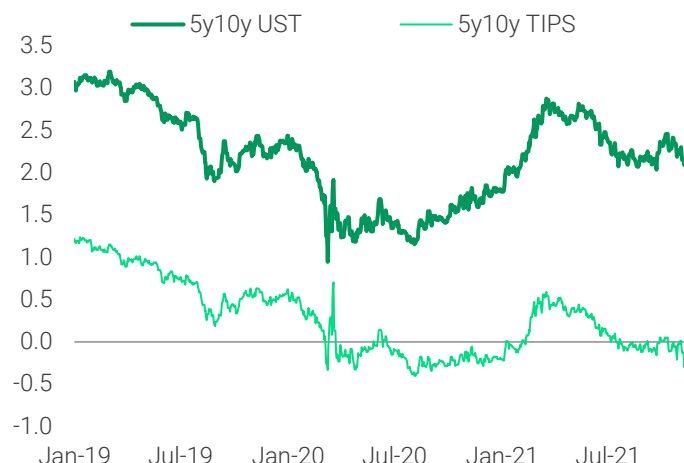
Sources: TS Lombard, Bloomberg.

10Y UST yield is structurally too low...



Source: TS Lombard, Bloomberg

...But, 5Y forward 10Y yields reflect only inflation



Source: TS Lombard, Bloomberg

10Y UST yield are structurally low and, above all, reflect inflation. Our simple, but effective model using the manufacturing ISM to forecast the US 10Y shows that yields are structurally too low. The current level of economic activity projects a 2.8% 10Y yield; but given that current forward nominal rates (5y/10y UST) include a marginally negative real yield, it can be concluded that compensation is solely an inflation premium. While we do expect growth to normalize in 2022, plugging in an ISM of just 50 implies that the 10Y should be at 1.69. For us, this means that even as growth slows (albeit to a level still above trend), there will continue to be enough room for real yields to rise as inflation expectations recede.

Technically, TIPS looks overbought. Therefore, we take this opportunity to **sell TIPS via TIP US ETF**.

Portfolio update

We have been short treasuries since June, expressing the view through nominal, as it had the added benefit of being a hedge against the risk of more persistent inflation. However, owing to the post NFP rally in Treasuries, we hit our stop of 131-16 and therefore we close out the position with a profit (~+2%). With inflation set to dissipate in 2022, we feel our short TIPS position is a better expression of higher yields in any case.