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Investments

Global macroeconomic update

Key themes

- After a relatively quick move in Q1 the march higher in rates has paused; curiously, despite some very strong US data
- While a lot of the fiscal news is getting priced in, the inflation data throughout Q2 will be key for the next part of the macro rates cycle
- For another leg higher in nominal rates, inflation data will likely need to print above expectations, but European vaccination rates and positioning are also key

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Something Curious Happened on the Way Up

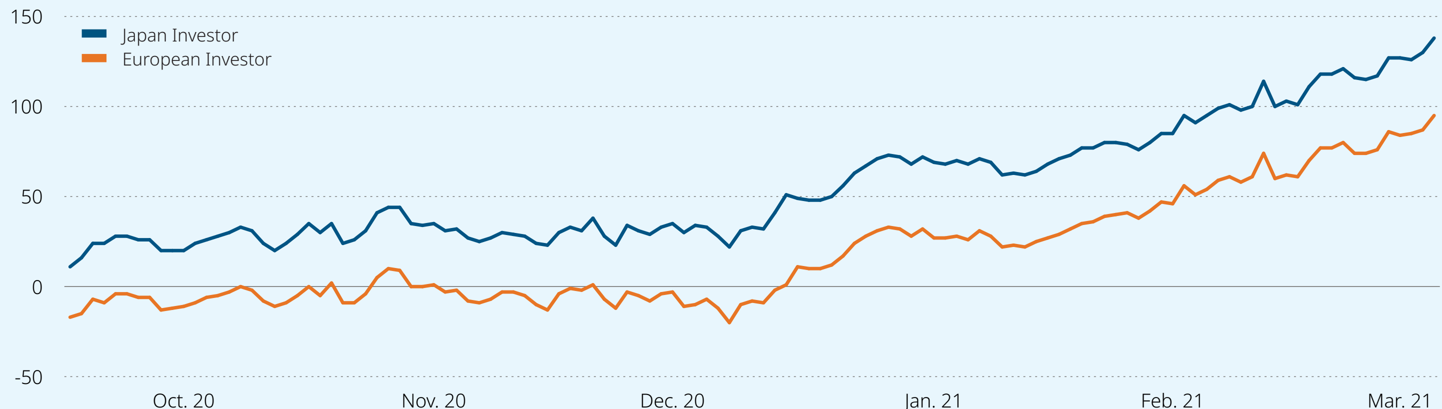
In our early January piece soon after the Georgia Senate runoffs ("Jekyll Island Strikes Again") we spoke about the need for a "recalibration of views" based on changing market and political dynamics with a bias towards higher rates. With tailwinds of a large US fiscal stimulus package coupled with a laissez-faire attitude from the Fed and a massive vaccine rollout among other macro drivers, 10yr US Treasury yields rose from 95bp on January 5, 2021, the day of the Georgia Senate runoffs to, 174bp by the end of the first quarter. The US Treasury 2s-10s steepened by around 78bp over the same period.

However, since the start of Q2/21 something very curious happened: there has been a distinctive lack of follow-through higher in rates despite exceptionally strong US data. First of note was the March ISM manufacturing report, the highest since 1983 while the prices paid sub-component was the second highest since 2008. Second, the March NFP report with revisions was well over a million jobs created, above consensus and even above what many were suggesting could be the "whisper" number. Third, the March ISM services report was highest on record while the prices paid sub-component was the highest since July 2008. All very strong indicators of upside economic momentum and prices and yet despite all of it nominal, breakeven and 10yr real rates have all trended lower since the end of Q1. Curious indeed.

When this type of price action occurs, the response is often "[I]t was already in the price" which is sometimes a bit of a throwaway. In this case it is probably somewhat appropriate given the magnitude of the rate move in Q1, and the recalibration that occurred, but we think the answer is likely a bit more nuanced. In our soundings, it is very tough to find a lot of market participants who are significantly long rates (expectations for yields to move lower) which suggests a lot of people are already in the higher rates trade. This also suggests thats it is somewhat "crowded" and, therefore, a positioning washout likely needs to occur before the next leg higher. Part of the answer probably also has to do with the recent Continental Europe Covid lockdown news and the vaccination gap between it and the US. With US Treasuries still seen by some as a "flight to quality" instrument particularly by non-North American investors and central banks and with the European Central Bank significantly more vocal compared with the Fed about not wanting nominal rates to move higher, European investors are likely looking at US Treasuries as a bit of a safe haven play versus the current German 10yr bund yielding -34bp (see chart 1). Not unrelated is the notion Japan's fiscal year just ended on March 31st and domestic investors are now probably less likely to be repatriating foreign assets (selling US Treasuries) and more apt to purchasing Treasuries going forward with the Japanese 10yr note yielding 9bp (see chart 1). Indeed the early data suggests Japanese domiciled investors have reversed course from selling Treasuries in February to becoming net purchasers towards the end of March even before fiscal year end in an attempt to capture some duration.

Chart 1 | Foreign Investors Hedged Yield in 10yr USTs

(bps, Daily, Oct. 2020 - Present)



Sources: Morgan Stanley, Bloomberg, Mackenzie Investments

So have we seen the peak in rates?

With US nominal GDP likely around 8% in 2021 we think not yet, and a further recalibration is likely. Fiscal policy remains a key driver, but the "surprise upside news" from fiscal appears to be somewhat in the price and we could be on the precipice of a thematic change for market drivers. In addition to a possible tactical positioning washout, we are watching with particular interest for the next few weeks and months the CPI data, and the impact from March, April and May 2020 when prices plunged versus what appears to now be an economy recovering faster than many have anticpated. It is widely assumed we will see strong CPI prints starting this month (for March) and for the next couple of months, but importantly our impression is there is a lot of sensitivity in the market around this data and any small upside surprise from higher expenditures due to pent-up savings, large spending from direct checks from the $1.9 trillion stimulus bill or higher gasoline prices would cause rates to move higher once again. And perhaps the move would not occur in an "orderly" fashion as Fed Chair Powell has labeled thus far. Sometimes overlooked, the retail sales data will also be important here - particularly for March and April as the effects of the stimulus checks work through the system - for any second derivative impacts and clues on consumer inflation, as will conditions surrounding the lockdowns and vaccine rollout in Continental Europe. An improvement in the take-up rate there should equate into less demand for US Treasuries on the safe haven bid and as a consequence provide some possible additional upside for yields.

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