4X Global Research

Olivier Desbarres | contact@4xgr.com | +44 (0) 20 3811 0454

Fixed Income Research & Macro Strategy (FIRMS) – 23rd July 2021

Not "risk-on" or "risk-off", rather What's the risk?

In the past fortnight US Treasury yields across the maturity spectrum have oscillated in reasonably wide ranges, with the highs coinciding with the release on 13th July of US CPI-inflation data. The shape of the yield curve today is almost the same as it was on 8th July.

The US rates market has tentatively found its feet, for now at least – tentatively because volatility remains reasonably high both in terms of yield levels and yield spreads.

The pace of Dollar NEER appreciation has also slowed and volatility remains low while the S&P 500 and Brent crude oil price have been choppy in multi-week ranges.

The inverse correlation between the Dollar NEER and S&P 500 has somewhat broken down so far this month. We estimate that since 28th June the S&P 500 and Dollar NEER have respectively gained about 1.8% and 1.2%.

In that sense the Dollar has not traded like a "safe-haven" asset, at least not in the purest sense of the term in our view. Instead the appreciation in the Dollar NEER since 10th June has largely coincided with the flattening of the 2s-10s Treasury curve.

Finally, the relative performance of major currencies does not clearly point to either "risk-on" or "risk-off" having prevailed, in our view. Since the 36-month low in the Dollar NEER on 10th June, weighted-baskets of EM currencies (excluding Renminbi) and developed market currencies have both depreciated about 3% versus the US Dollar.

Our overall take is that US (and global) markets in recent weeks can neither be categorised as "risk-on" or "risk-off". Instead it has been a case of "what is the risk?".

Specifically we think markets are still weighing whether i) they should be more concerned about a potential slowdown in US and global growth or CPI-inflation remaining sticky at high levels and ii) how central banks will adjust monetary policy, in terms of their QE programs and outlook for policy rate hikes (an arguably granular picture at present).

Macro data point to rapid global economic growth having slowed in June (but remained positive) and we will elaborate on our outlook in the next *FIRMS* report.

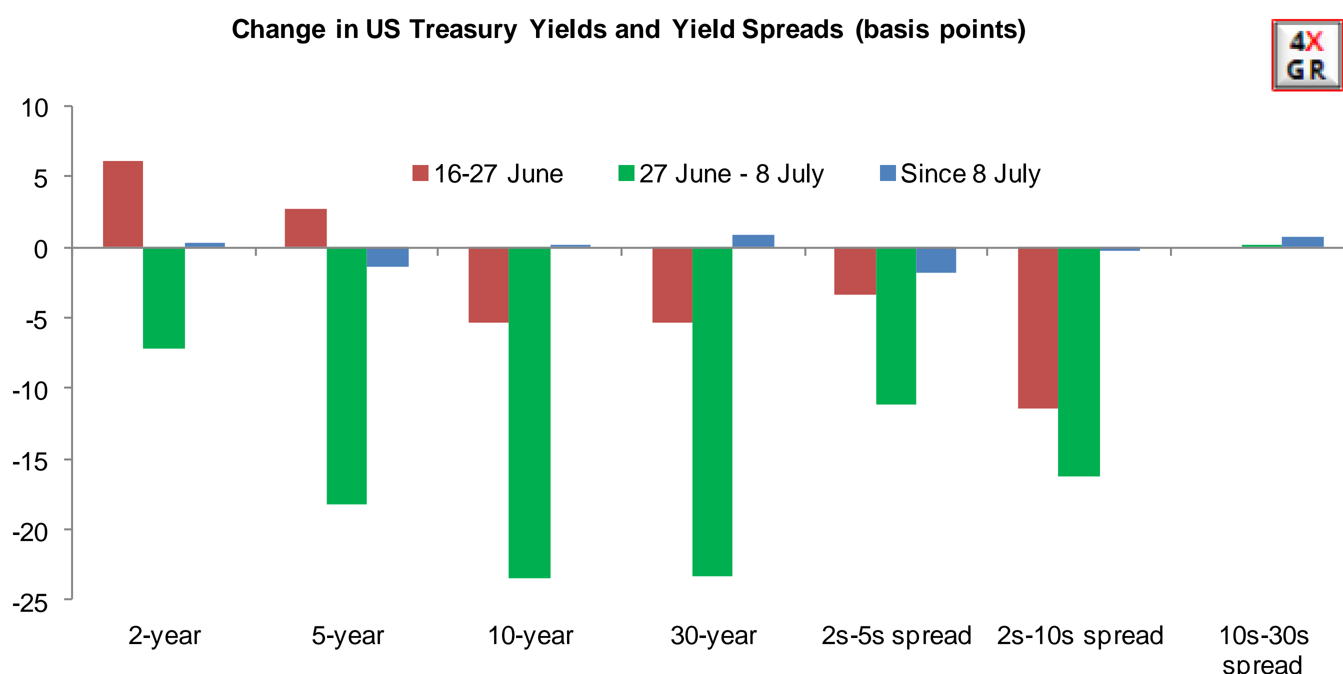
Treasury markets have settled in ranges in past fortnight after turbulent three weeks

The performance of US Treasury yields since the Federal Reserve's 16th June policy meeting and the accompanying "narrative" can be broken down into three distinct phases:

1) 16th June – 27th June: Bearish flattening

Two-year yields rose sharply while 10-year yields remained elevated around 1.5% in the wake of the Federal Reserve's policy meeting (see Figure 1). The narrative was a rather simple one, namely that the Federal Reserve had turned more hawkish, as evidenced by upward revisions to its CPI-inflation and GDP growth forecasts for 2022 and perhaps more notably the shift in the FOMC "dot-plot" (see Fed: Same game, different rules, 22nd June 2021).

Figure 1: After three weeks of commotion US Treasury yields have in past fortnight been range-bound



Source: *4X Global Research, investing.com*

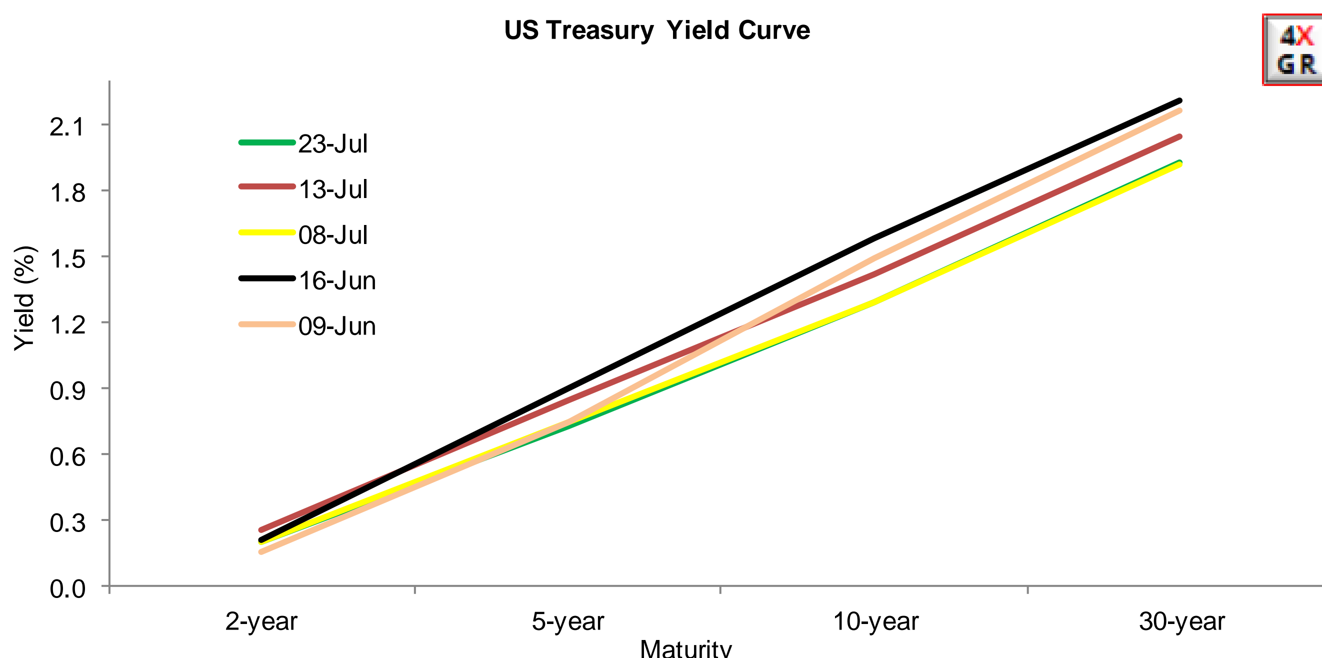
2) 27th June – 8th July: Bullish flattening

Two-year yields fell below 0.2% and long-end yields collapsed as concerns about a possible slowdown in domestic and global economic growth started to surface and significant short Treasury positions and (carry positive) yield- steepener positions were unwound.

3) Since 8th July: Wide-ranges and volatility but shape of curve broadly unchanged

In the past fortnight US Treasury yields across the maturity spectrum have oscillated in reasonably wide ranges, with the highs coinciding with the release on 13th July of a higher-than-expected rise in US CPI-inflation in June (in the greater scheme of things the markets' reaction to this inflation release was far dramatic apart from at the very front-end of the US rates curve. Not so much market awe as an acknowledgment that the Federal Reserve will at some point need to tighten monetary policy in order to ensure that high US inflation indeed proves transitory). **The shape of the yield curve today is almost exactly the same as it was on 8th July** (see Figure 2).

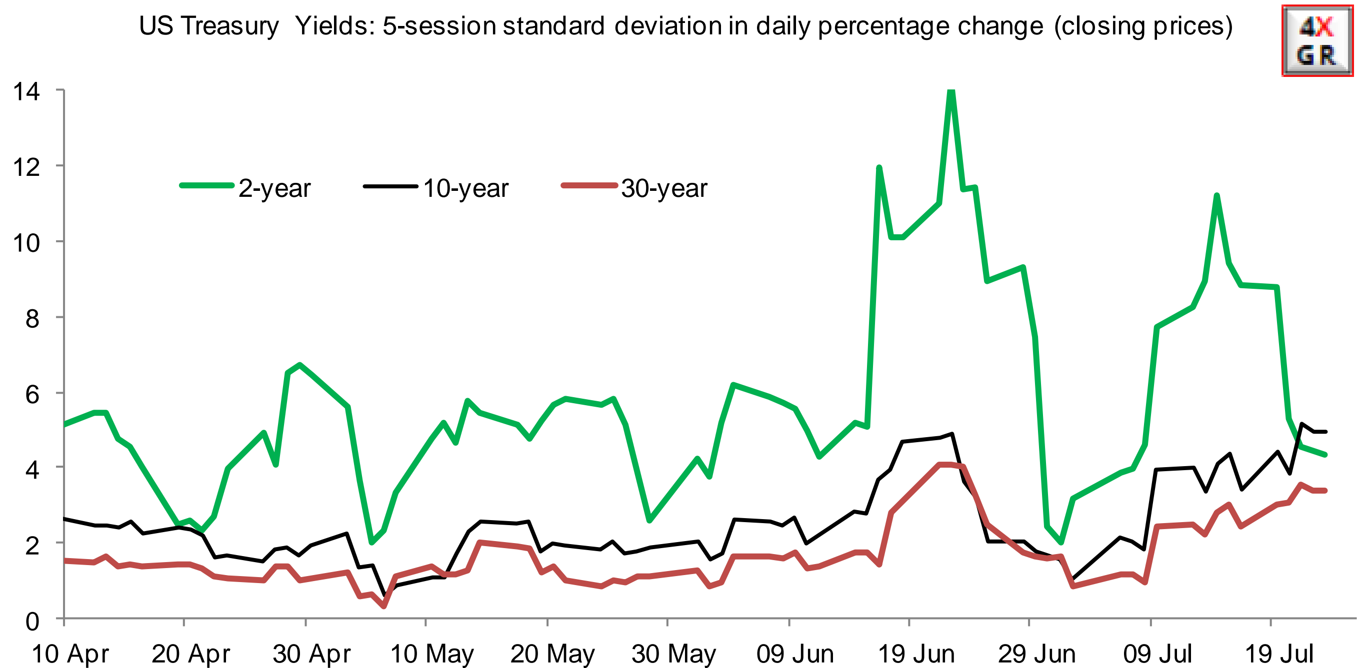
Figure 2: Shape of the US Treasury yield curve almost the same as it was a fortnight ago



Source: *4X Global Research, investing.com*

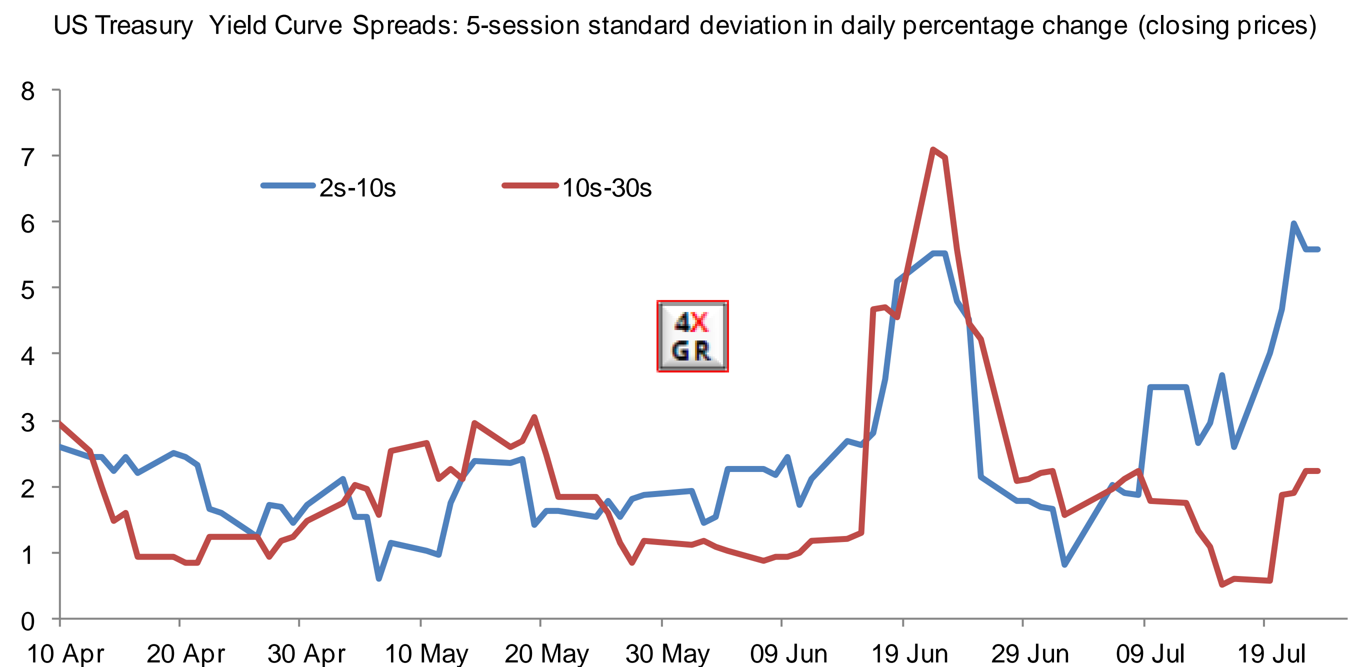
The US rates market has tentatively found its feet, for now at least – tentatively because volatility remains reasonably high both in terms of yield levels, particularly at the long-end (see Figure 3), and yield spreads (see Figure 4).

Figure 3: Volatility in US Treasury yields remains relatively high across the maturity spectrum…



Source: *4X Global Research, investing.com*

Figure 4: … and shape of the US rates curve remains fluid, pointing to still uncertain financial markets



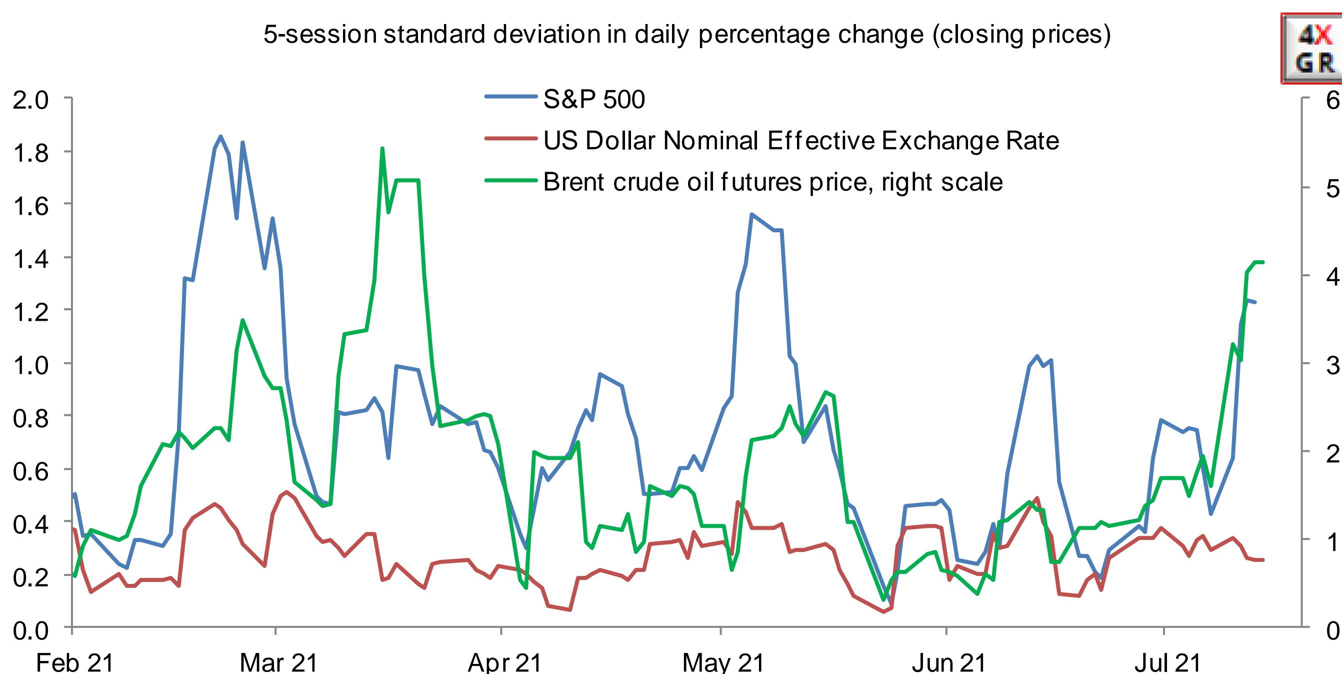
Source: *4X Global Research, investing.com*

The narrative, in our view, is that market concerns about slowing US and global growth – or at least the prospect of slowing growth – have effectively cancelled out market concerns about year-on-year CPI-inflation in the US (and globally) remaining sticky at high levels and forcing the Federal Reserve to tighten monetary policy sooner rather than later. Put differently, since the clear-out between 27th June and 8th July, markets in net-terms have seemingly not been willing to take an outright hawkish or dovish position.

Pace of Dollar rally has slowed while equities and crude oil treading water (but volatile)

Even the US Dollar's appreciation has lost steam since 8th July and its volatility has remained low (see Figure 5). The Dollar Nominal Effective Exchange Rate (NEER) appreciated 2.3% between 10th June (a 36-month low) and 8th July but has since appreciated only 0.5%, according to our estimates (see Figure 6).

Figure 5: While volatility in S&P 500 and crude oil prices has risen, Dollar volatility has remained low

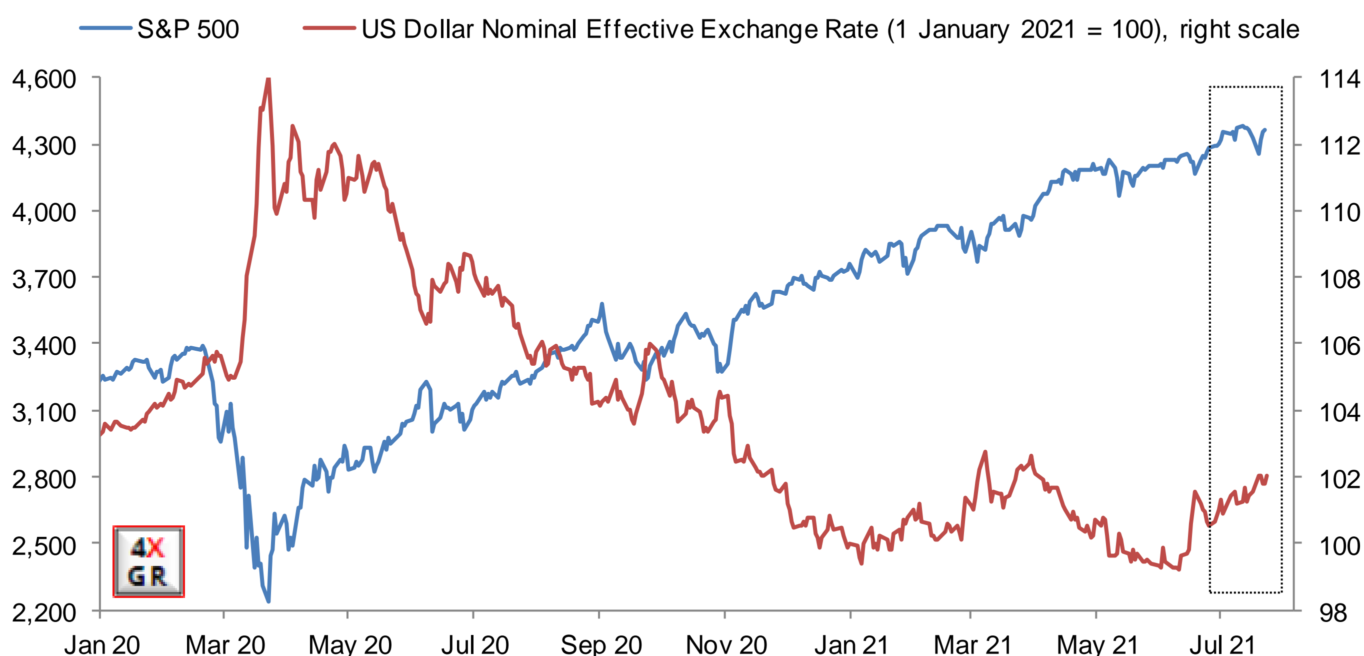


Source: 4X Global Research, Federal Reserve, investing.com

It has arguably been a similar pattern, albeit over a slightly longer timeframe, for US equities and international crude oil prices. After having rallied seven consecutive sessions between 24th June and 2nd July (a cumulative gain of 2.6%), the S&P 500 has been stuck in a wide 3.0% range, closing yesterday up only 0.3% from 2nd July. Volatility, as measured by the five-session standard deviation in the S&SP 500's daily percentage change, has tripled in the past week (see Figure 5). The Brent crude oil futures price is currently near the middle of an 8-week range of about 11.5% but again volatility has recently picked up.

We also note that the inverse correlation between the US Dollar NEER and S&P 500, which has prevailed throughout most of the past 18 months, has somewhat broken down so far this month. We estimate that since 28th June the S&P 500 and Dollar NEER have respectively gained about 1.8% and 1.4% (see Figure 6). In that sense the US Dollar has not traded like a "safe-haven" asset, at least not in the purest sense of the term, in our view.

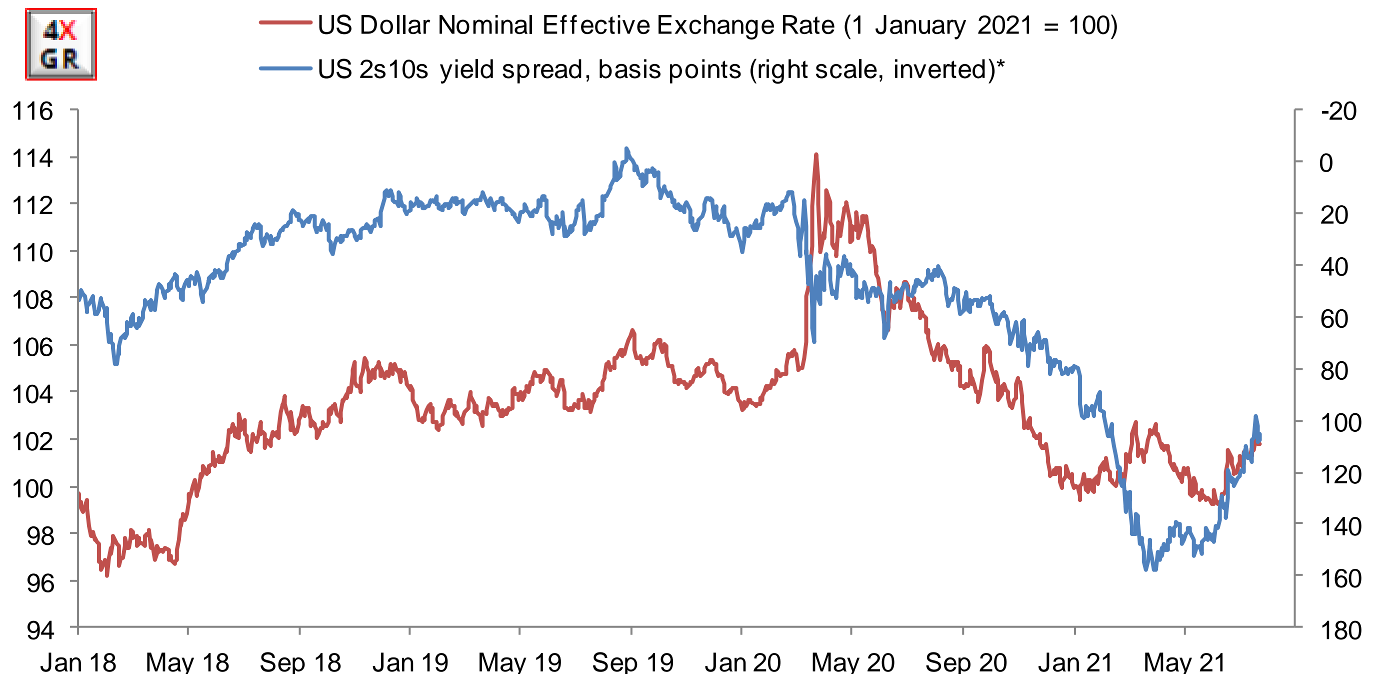
Figure 6: Inverse correlation between Dollar NEER and S&P 500 has broken down since end-June



Source*: *4X Global Research, Federal Reserve, investing.com

Instead the appreciation in the Dollar NEER since 10th June has largely coincided with the flattening of the 2s-10s Treasury curve (see Figure 7). The market was arguably short US Dollars and long-end rates going into the Federal Reserve's policy meeting but quickly started to liquidate these positions as concerns about economic growth started to surface.

Figure 7: Dollar rally in past six weeks has coincided with flattening of the US Treasury yield curve



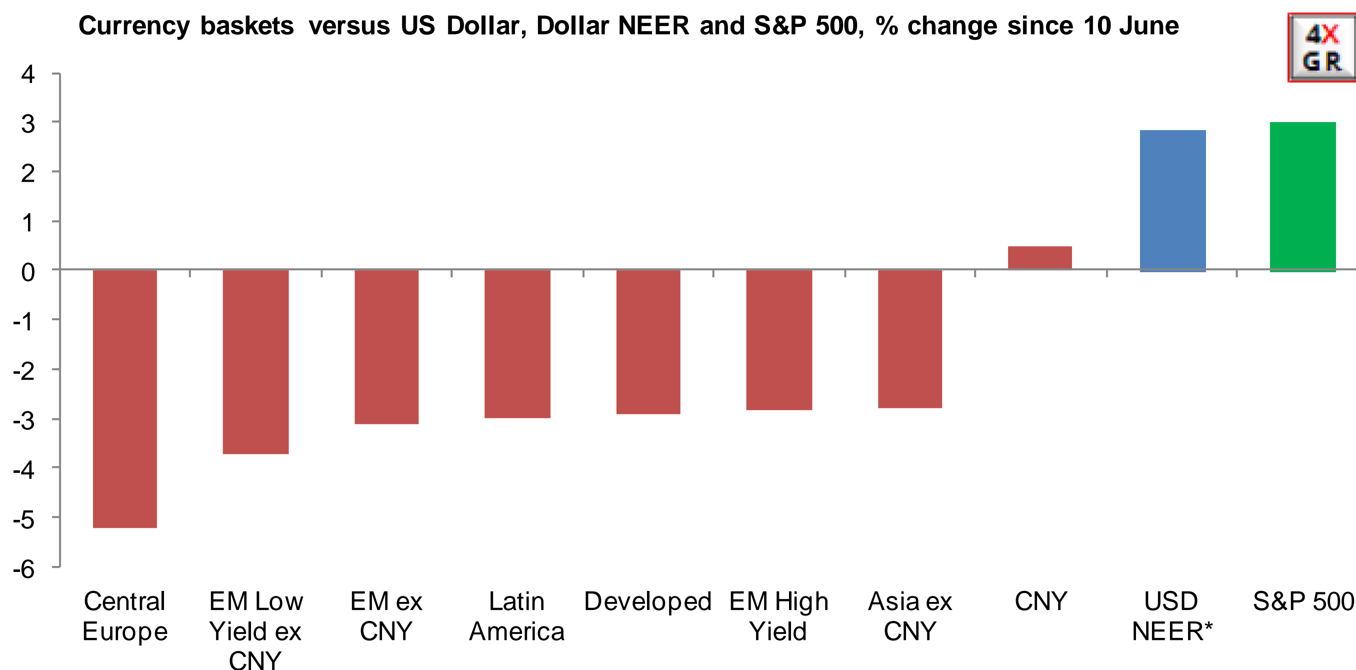
Source: *4X Global Research, Federal Reserve, investing.com*

*Note: *10-year yield minus 2-year yield*

Finally, the relative performance of major currency blocks does not clearly point to either "risk-on" or "risk-off" having prevailed, in our view.

Since the multi-month low in the US Dollar on 10th June, a weighted-basket of Emerging Market (EM) currencies (excluding the Chinese Renminbi) has depreciated about 3.1% versus the Dollar, according to our calculations, while a GDP-weighted basket of developed market currencies has weakened about 2.9% (see Figure 8). So no clear distinction performance between "risky" and "less-risky" currencies. Within EM currencies, high-yielding currencies (-2.8%) have slightly outperformed low-yielding currencies (-3.7%), which at the margin would typically point to a "risk-on" environment. Nevertheless that is a tough case to make when the supposedly "safe-haven" Dollar has appreciated 2.6% over that time period.

Figure 8: Dollar and S&P both up, EM and developed currencies level-pegging = neither "risk on" or "risk off"



Source: 4X Global Research, Federal Reserve, IMF, investing.com

*Note: * USD NEER is US Dollar Nominal Effective Exchange Rate (Federal Reserve trade weights).*

Markets weighing whether they should be worried about slowing growth or high inflation

Our overall take is that US (and global) markets in recent weeks can neither be categorised as "risk-on" or "risk-off". Instead it has been a case of "what is the risk?" Specifically, as already mentioned above, we think that markets are still weighing whether going forward i) they should be more concerned about a potential slowdown in US and global economic growth or about year-on-year CPI-inflation remaining sticky at high levels and ii) how developed market central banks will adjust monetary policy, both in terms of their QE programs and outlook for policy rate hikes.

The central bank picture is already very granular, in our view.

- **Reserve Bank of New Zealand** stated on 13th July that it will stop buying government bonds under its large-scale asset purchase (LSAP) programme by 23rd July. Markets are also pricing in a high probability that the RBNZ will hike its policy rate 25bp to 0.50% at its next meeting on 18th August.

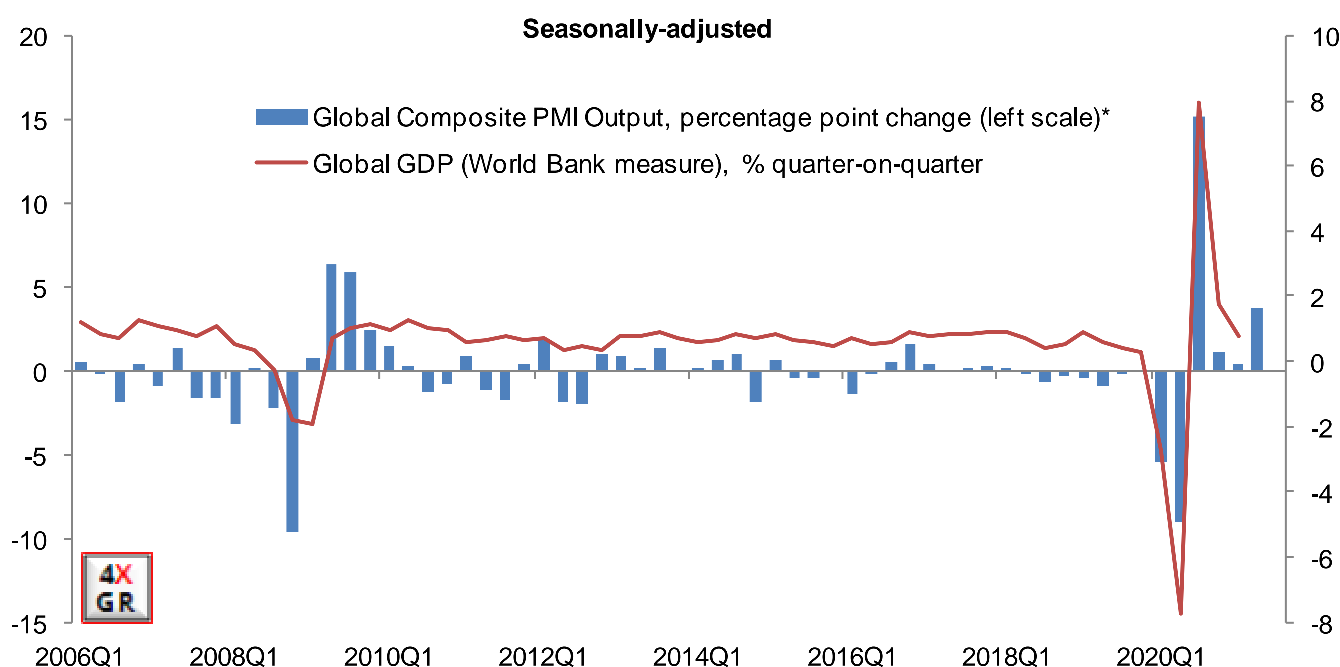
- **Bank of Canada** has halved its weekly asset purchases to CAD 2bn since April although the central bank said at its 14th July policy meeting that it does not expect to hike rates before the second half of 2022.

- **Bank of England** (at least implicitly) started to taper its bond purchases in mid-May (see Sterling's coming home…albeit slowly, 16th July 2021);

- **Reserve Bank of Australia** announced on 6th July that it would cut its weekly bond purchases to AUD4bn from September, down from AUD 5bn currently;

At the other end of the spectrum the **European Central Bank** made clear at its policy meeting yesterday that it plans to keep monetary policy very accommodative medium-term. The **Federal Reserve** arguably sits somewhere in the middle, with the FOMC having started to talk about when it should announce that it will start to taper its asset purchases (some analysts believe it will do so at the Jackson Hole Symposium on 26-28 August). The picture is even more differentiated when EM central banks are thrown into the mix, with central banks in Brazil, the Czech Republic, Hungary, Mexico and Russia having all hiked their policy rates since early June.

Figure 9: Global GDP growth likely accelerated in Q2, thanks in part to re-opening of economies…



Source: 4X Global Research, IHS Markit/JP Morgan, World Bank

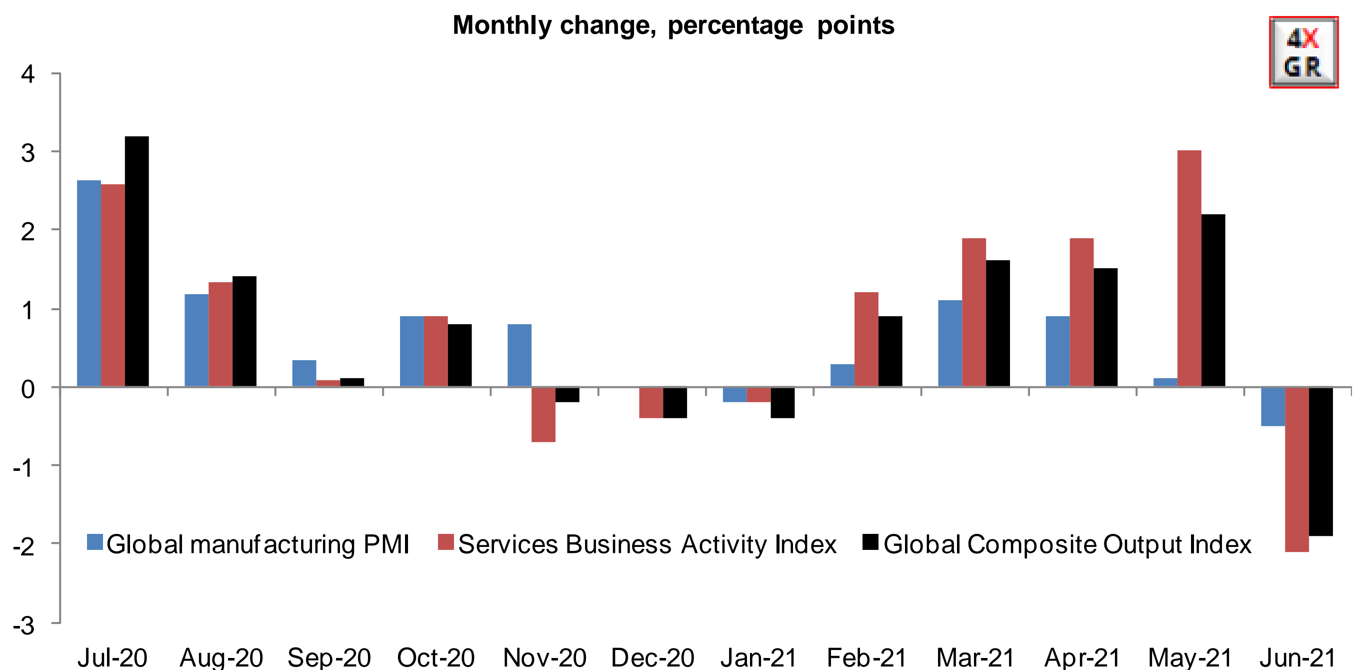
*Note: * The Global Composite Output Index, commonly referred to as the Global Composite PMI, is a weighted average of the Global Manufacturing Output Index (which accounts for 25% of the Global Manufacturing PMI) and the Global Services Business Activity Index (one of the eight components of the Services Index).*

With regards to the outlook for US/global economic growth and CPI-inflation, the focus of our next *FIRMS* report, as a starting point we would argue that price action in recent weeks (as detailed above) points to

markets' twin concerns being still modest rather than acute. Macro data, while still tentative, suggest that global economic growth slowed in June but remained positive (i.e. the first derivative of global output was positive, but the second derivative negative).

Historically quarter-on-quarter global GDP growth has correlated closely with the quarterly change in the Global Composite PMI (see Figure 9). Based on this relationship, the jump in the Global Composite PMI to 57.1 in Q2 from 53.4 in Q1 suggests that global GDP growth accelerated in Q2 from about 0.8% qoq in Q1. However, the Global Composite PMI fell 1.9 percentage points in June to 56.6 (see Figure 10). While a figure above 50 indicates positive growth in economic activity, the fall in June points to slower growth albeit from elevated levels.

Figure 10: … but signs that rate of economic growth may have slowed in June albeit from high level



Source*: *4X Global Research, IHS Markit/JP Morgan

DISCLAIMER & DISCLOSURE STATEMENT

THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER OR A SOLICITATION OF AN OFFER TO BUY OR SELL ANY SECURITY IN ANY JURISDICTION WHERE SUCH OFFER OR SOLICITATION WOULD BE ILLEGAL; AND (III) BASED UPON INFORMATION THAT WE CONSIDER RELIABLE.

4X GLOBAL RESEARCH DOES NOT WARRANT OR REPRESENT THAT THE PUBLICATION IS ACCURATE, COMPLETE, RELIABLE, FIT FOR ANY PARTICULAR PURPOSE OR MERCHANTABLE AND DOES NOT ACCEPT LIABILITY FOR ANY ACT (OR DECISION NOT TO ACT) RESULTING FROM THE USE OF THIS PUBLICATION AND RELATED DATA. TO THE MAXIMUM EXTENT PERMISSIBLE ALL WARRANTIES AND OTHER ASSURANCES BY 4X GLOBAL RESEARCH ARE HEREBY EXCLUDED AND 4X GLOBAL RESEARCH SHALL HAVE NO LIABILITY FOR THE USE, MISUSE, OR DISTRIBUTION OF THIS INFORMATION.

The analysis and information presented in this report (Report) by 4X Global Research Ltd (4X Global Research), an independent research company registered in the UK, is offered for subscriber interest only. The content is intended for investment professionals only, and is not to be viewed or used by individual investors in any regulatory jurisdiction. By accessing this Report you confirm that you meet these criteria.

This Report is not to be used or considered as a recommendation to buy, hold or sell any securities or other financial instruments and does not constitute an investment recommendation or investment advice. The information contained in this Report has been compiled by 4X Global Research from various public and industry sources that we believe to be reliable; no representation or warranty, expressed or implied is made by 4X Global Research, its affiliates or any other person as to the accuracy or completeness of the information. 4X Global Research is not responsible for any errors in or omissions to such information, or for any consequences that may result from the use of such information. Such information is provided with the expectation that it will be read as part of a wider investment analysis and this Report should not be relied upon on a stand-alone basis. Past performance should not be taken as an indication or guarantee of future performance; we make no representation or warranty regarding future performance. The opinions expressed in this Report reflect the judgment of 4X Global Research as of the date hereof and are subject to change without notice.

This Report is not, and should not be construed as, an offer or the solicitation of an offer to buy or sell any securities. The offer and sale of securities are regulated generally in various jurisdictions, particularly the manner in which securities may be offered and sold to residents of a particular country or jurisdiction. Securities referenced in this Report may not be eligible for sale in some jurisdictions. To the fullest extent provided by law, neither 4X Global Research nor any of its affiliates, nor any other person accepts any liability whatsoever for any direct or consequential loss, including without limitation, or lost profits arising from any use of this Report or the information contained herein.

No director, officer or employee of 4X Global Research is on the board of directors of any company referenced herein and no one at any such referenced company is on the board of directors of 4X Global Research. 4X Global Research does not invest in any securities although it is possible that one or more of 4X Global Research's directors, officers, employees or consultants may at times be invested in the securities referenced.

4X Global Research is not authorized or regulated in the United Kingdom by the Financial Conduct Authority (FCA) or by any other regulator in any jurisdiction for the provision of investment advice. Specific professional financial and investment advice should be sought from your stockbroker, bank manager, solicitor, accountant or other independent professional adviser authorized pursuant to the Financial Services and Markets Act 2000 if you are resident in the United Kingdom or, if not, another appropriately qualified independent financial adviser who specializes in advising on the acquisition of shares and other securities before any investment is undertaken.

This Report, including the text and graphics, is subject to copyright protection under English law and, through international treaties, other countries. No part of the contents or materials available in this Report may be reproduced, licensed, sold, hired, published, transmitted, modified, adapted, publicly displayed, broadcast or otherwise made available in any way without 4X Global Research's prior written permission. All rights reserved. This document is produced using open sources believed to be reliable. However, their accuracy and completeness cannot be guaranteed. The statements and opinions herein were formed after due and careful consideration for use as information for the purposes of investment. The opinions contained herein are subject to change without notice. The use of any information contained in this document shall be at the sole discretion and risk of the user. Investors should consider this report as only a single factor in making their investment decision and, as such, the report should not be viewed as identifying or suggesting all risks, direct or indirect, that may be associated with any investment decision.

No liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient acting on such information or opinion or estimates. 4X Global Research employees may have or take positions in the markets and securities mentioned in this document. The stated price of any securities mentioned herein is not a representation that any transaction can be effected at this price. Investing in securities may entail certain risks. The securities referred to are not suitable for all investors and should not be relied upon in substitution for the exercise of independent judgment. This material is not directed at you if 4X Global Research is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. 4X Global Research and its analysts are remunerated for providing independent investment research to financial institutions, corporations, and governments.

DISCLOSURE: This Report is not to be copied, forwarded or otherwise disseminated to non-subscribers in electronic or physical form without prior consent.