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LUND UNIVERSITY FINANCE SOCIETY EST 1991

INVESTMENT RESEARCH REPORT

LATE CYCLE IS NOT END CYCLE

”Opportunities in the front end of the US Yield
Curve”

Beta to Alpha: Opportunities at the front end of the US yield curve

Executive Summary: The US economy has continued to expand for almost a decade, prompting policymakers at the US Fed to raise interest rates for the third time this year, to 2.25%. Moreover, a rising rate environment spurred by QT from the Fed and ECB could prompt more late-cycle signs, thus maintaining downward pressure on long-term bond yields, as financial conditions tighten. However, in such an environment, an apparent asymmetric risk and reward dynamic have made short-term bonds relatively more attractive to invest in currently. Thus, flattening of the yield curve often perceived as a harbinger presents opportunities in the front-end of the yield curve. Therefore, we suggest an active management strategy through, e.g., a bond ladder strategy in order to tap yield at the front end of the curve.

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- **The yield curve is flattening** as the short-end has been climbing faster than the long-end through 2018 with increased QT from the Fed, a common trend in the late cycle. This flattening is likely to continue as the Fed aims for the neutral rate. (Exhibit 1).
- **Yield curve inversion** may not be a reliable signal for a looming recession as it has been previously. Due to the unknown effects of QE on the long-end of the curve, the long-end is uncertain. The short-end however, is known and more certain. With both US Fed and ECB QT, the world is entering a paradigm shift, where the river of easy money is drying up and revealing the bottom of the river floor.
- **LOIS has widened** during 2018 and currently stands at approximately 34 basis points (Exhibit 2). Such a move typically signals some sort of credits market stress, i.e. banks having difficulty for short-term funding. However, the possible primary driver is the increased T-bill issuance to meet debt-ceiling impasses and larger government and current account deficits. Furthermore, due to the repatriation of assets made possible by tax-reform, investors' demand for front-end assets has declined. As such, the widening reflects opportunities in short-term liquidity options.
- **Late cycle** is not the end cycle, low volatility during 2017 was an outlier, but we believe that with the uncertain future implications from trade tariffs, slowdown of global growth, bottleneck effects of U.S domestic market and QT, volatility is prone to make a comeback in the new era (Exhibit 3). Where short-term liquidity options may offer less idiosyncratic exposure to risk and positive gains through a bond-ladder strategy.

EXHIBIT 1: Flatter US Yield Curve

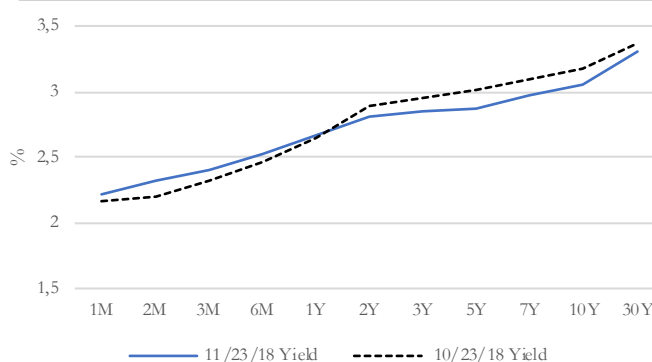


EXHIBIT 2: LIBOR OIS (LOIS)

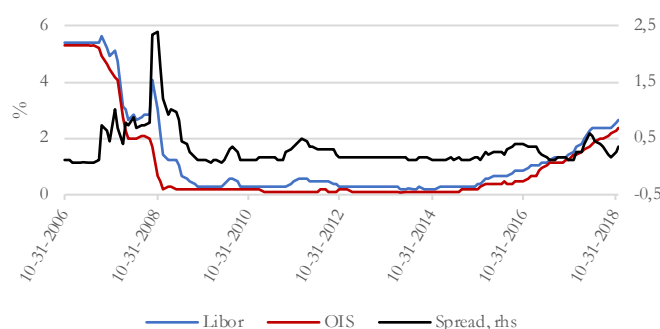
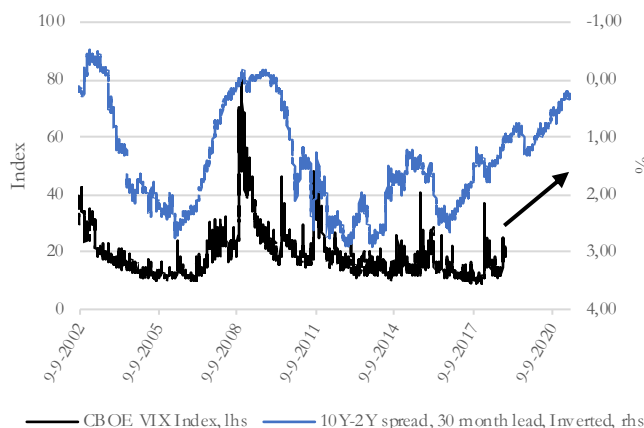


EXHIBIT 3: CBOE VIX Index



FRONT END OF THE US YIELD CURVE

EXHIBIT 4: Late-Cycle

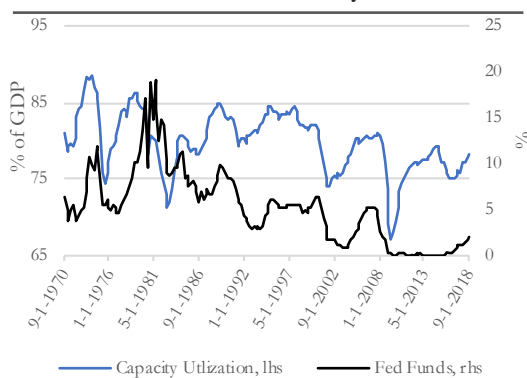


EXHIBIT 5: FOMC Dot Plot

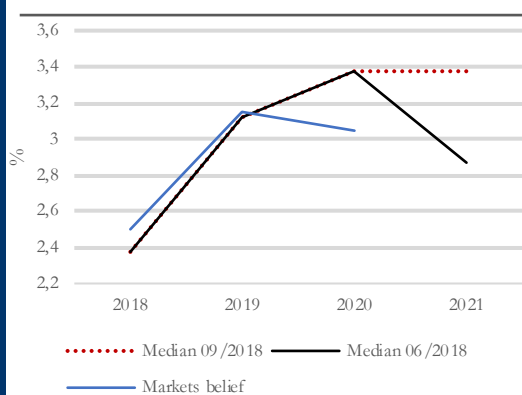


EXHIBIT 6: Duration Model

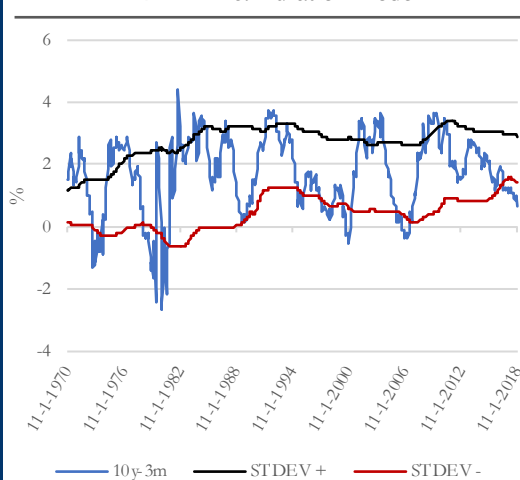
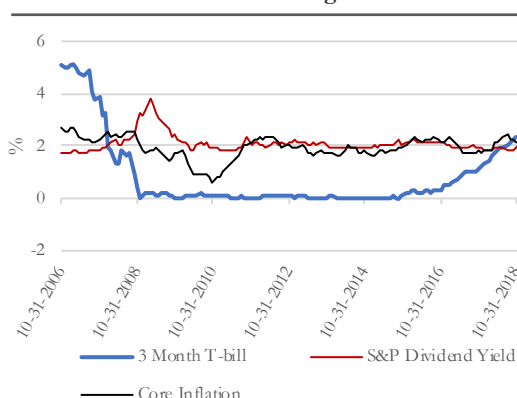


EXHIBIT 7: Paradigm Shift



Growing but slowing. Exhibit 4 shows that since 1970, each peak in capacity utilization has been followed by a minor peak; which is the same trend recorded by the effective funds rate. The U.S economy has either passed its peak or is very close to the peak, but we believe in the former for cap utilization. Which is segmented in, e.g., durable goods order recording a 4.4% decline in Oct 2018 MoM. Furthermore, both the Atlanta Fed GDPNow indicator and NY Fed Nowcast are forecasting slower real GDP growth at 2.5% for the fourth quarter YoY compared to the previous forecast of 2.7-2.9%. Still above the trend line, however the trend of a slowdown is likely to continue through 2019.

Impending inflation. Bottleneck effects are materializing, where unemployment has reached a 50-year low at 3.7%, below the NAIRU at 4.62, where hourly earnings peaked up and reached 3% Oct YoY. Headline inflation might decrease due to an oil price plunge, but the Fed only cares about core inflation, ex. Energy and Food, which has consistently stayed above the 2% target since March this year. Bottom-line, the U.S economy is growing but slowing as growth seems to be accommodative through 2019, prompting the Fed to hike. Furthermore, the unknown future effects of the current and imminent trade tariffs on prices might materialize sooner than expected, creating a possible inflation surprise.

Near neutral rate. The latest FOMC minutes created a rally in global stocks and high yield indexes. The market reacted idiosyncratically to Powell's dovish tone, however, Powell stated that "rates are just below the broad range of estimates of the level that would be neutral," a more dovish tone compared to earlier remarks "far below neutral." Whereas markets seemingly noted "Rates are below neutral". The Fed funds rate is currently within the range of 2.00% to 2.25%, after eight rate hikes since December 2015. This means that the Fed is one increase away from the lower part of the range, three increases from the middle and five increases from the top (Exhibit 5). Going forward, core inflation and wage growth will be key determinants, and after a period of low interest rates, a return to/close to neutral would be healthy for financial stability. Where volatility is poised to increase with higher rates, as higher rates tighten economic conditions (Exhibit 3).

Shorten duration. Computing a duration model with the 10y-3-month treasury spread, with one standard deviation \pm from the 10y moving average (Not highlighted), suggests shorting duration (Exhibit 6). In a time where the US economy is showing late-cycle symptoms, this suggestion offers opportunities, as short-term bonds are more resilient to risks inherent in apparent interest rate hikes, that the market is currently pricing in. In fact, in 2018, the S&P 500 has offered volatility of 13%, long-term bonds volatility of 8%, while short-term bonds offered volatility of less than 1%, on the average.

Positive real returns. Flatter yield curve has made it possible for short-term bond investors to earn almost as much they would from investing in long-term bonds, for less risk and a reduced price. Short-term bonds are generally more liquid than longer-term bonds and offer investors the flexibility to reinvest relatively quickly in other assets, hence the flexibility to adapt to changing market conditions. Lastly, short-term bonds offer positive real returns prompting a paradigm shift (Exhibit 7).

Bond ladder strategy. The strategy offers flexibility for the short-term and long-term investor. With a bond ladder strategy using the 3-month t-bill (as proxy for all short-term bonds, i.e., bonds with maturity >1), higher returns can be realized in an environment with rising rates. Currently, the 3-month is yielding 2.36% on an annual basis and expected to go higher with the current trend. Thus, holding a 3-month until maturity and reinvesting the proceeds in a 3-month on a rolling basis, realizes higher returns. If rates are falling in the future, its likely a response to a market downturn, thus, holding a 3-month offers the flexibility to buy stocks cheaper. Hence, the strategy is viable for short-term investors who need liquidity when markets are drying up, and it offers long-term investors the same opportunities to be flexible and reduce risk in their portfolio. Furthermore, the 10y reached 3.2% early Oct, just to decline to 2.99% 30th Nov, going forward the 10y should reflect risk more than VIX and work as yield curve flatter. As such we suggest the Bond ladder strategy, tapping yield at the front-end of the yield curve.

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