Insights

February 20, 2020

clearwater ADVISORS

Negative Real Yields and Buoyant Equities Send Mixed Signals

Relative to Covid-19, a possible Middle East conflict with Iran at the beginning of the year was met with little fanfare by Treasury markets. The 10-year Treasury yield held steady in the 1.80-1.90% range as the prospect for war was overshadowed by the signing of the "phase one" deal with China.

Today's Treasury market appears to be positioning itself for a dire outcome from Covid-19 with yields in the 1.50-1.60% range. Real 10-year yields (nominal yield minus TIPS break-evens) are currently -0.09%, and have been negative for over two weeks. This means investors are willing to forego compensation for future inflation in order to lock-in a low nominal return. Negative real yields have been a reality for Japan and developed European countries for some time now, but in recent years, real yields in the US have only turned negative following Brexit in 2016 and an escalation of trade tensions in 2019. More importantly, these prior episodes of negative yields lasted only a few days.

In contrast with the cautious reaction from the Treasury market, equities have brushed off concerns and continue to push to new highs. Even after Apple alarmed markets by announcing that coronavirus-related shutdowns would cause it to miss current quarter guidance, shares quickly rebounded erasing all losses. Many other companies have been less certain about the effects on operating results. However, to their credit, we believe it is still too early to quantify.

The sanguine response from equity markets can be attributable to expectations that the Fed will provide monetary support should global economic conditions deteriorate. Fed officials have also indicated that it is too early to determine what lasting disruptions Covid-19 will create; as such, monetary policy remains in a good place for now. Nonetheless, fed fund futures are currently pricing 1.5 cuts by the end of the year with the first cut fully priced in for the September FOMC meeting.

We think the appropriate positioning amid diverging messages from the rates and equity markets lies somewhere in the middle. The harsh and decisive response to limit contagion will undoubtedly have a near-term impact to global growth so we will seek to limit our credit exposure to cyclical industries such as energy, metals and automobiles, and instead allocate maturities and new money in more defensive sectors such as ABS where US consumers will be more insulated from the direct effects of Covid-19. On the other hand, we think that monetary and fiscal support from the Chinese government will ensure that supply chains are not permanently impaired. Therefore, we will seek to underweight duration in anticipation that global growth will eventually stabilize and return to potential.