ODDO BHF

MARKET *view*

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The "Rentier" is doing better

> *We are reducing our exposure to credit risk after an impressive spread tightening. On the other hand, we are lengthening the duration of portfolios that hold mainly US sovereign bonds.*

While we ended 2022 with expectations of zero growth, or even a moderate recession, the global economy has surprised us. So much so, that we are now shifting from fears of little to no growth to the complete opposite: fears of too much growth, which could force central banks to raise rates more than expected to tame inflation.

This fear is particularly palpable in the United States. The core PCE deflator rose by 0.6% in January, compared with forecasts for a 0.4% increase. The prices paid component of the ISM manufacturing index jumped to 51.3 from 44.5 last month. Since the start of February, the market's estimate of the terminal rate of the Fed has risen by 60 basis points to 5.50%, causing the yield on 10-year Treasury bonds to rise by 67bp, from 3.40% to 4.07%.

We had significantly reduced the duration of our portfolios in response to the series of inflationary shocks over the past three years. It is now appropriate to consider extending it, notably through a potential repositioning on US sovereign bonds.

1. What is the relationship between the central banks' rate and the yield on 10-year Treasury?

The Federal Reserve will update its economic and interest rate projections at its meeting later this month. Investors will certainly have a clearer idea of the future path of federal funds rates. However, a great deal of uncertainty will remain as to how much the 10-year US Treasury yield will rise.

For example, during the 2004-2006 tightening cycle, the federal funds rate reached 5.25% and the 10-year Treasury yield peaked at about the same level. Today, the Fed is poised to raise short term rates to similar levels, but the 10-year Treasury yield remains much lower.

Should we expect the 10-year Treasury yield to jump to 5% this time around? Probably not.

To understand why, we can use a simple model to estimate the 10-year Treasury yield based on the Federal funds rate, inflation expectations and potential GDP growth. The model shows that the main difference between the mid-2000 and today, is that potential GDP growth is much lower, implying a lower breakeven interest rate.

If we hold inflation expectations (2.5% from the break-even inflation market data) and potential GDP growth constant (1.5%) and assume that the federal funds rate increases to 5.25%, the model shows a 10-year Treasury yield at around 4%. Even if we push the expected federal funds rate to 6%, the value estimated by the model only just reaches 4.25%. The sensitivity to short term rates decreases as rates rise, which is intuitive.

Based on this analysis, and all else being equal, it is safe to say that any move above 4% in the 10-year Treasury yield is a buying opportunity.

2. What about inflation and growth assumptions?

Our chief economist forecasts 1.5% US growth in 2023. We will not take active bets on inflation but use the 10-year break-even point.

Should inflation rise again significantly, the decision to increase duration would obviously need to be reconsidered.

On the other hand, the risk of a recession cannot be ruled out for 2024, although it's been considerably reduced for 2023. The risk is therefore to the downside on growth, which makes it all the more favourable to reweight bonds.

Moreover, let's not forget that a 4% yield also provides carry and can partially or even totally limit capital loss in case of rising rates. As long as rates do not rise above 4.42%, you will not lose any money on 31 December 2023, an assumption that seems quite reasonable in the current context.

3. Which strategy by asset class?

Equities: We remain constructive but a little more cautious due to the recent rebound. We are returning to a neutral or even a slightly underweight position, particularly on US equities. Let's also keep in mind that the effects of monetary tightening will soon start to be felt and may weigh on growth and thus, margins. Today, we consider that the 5.4% return offered by US equities (with a forward 12-month earnings multiple of 18.5x) does not offer any relative value compared to... risk-free cash, which should soon offer the same returns.

The situation of the European market is a bit different. The Eurostoxx 50 offers a return prospect of 8% well above money market rates or even bonds, including high-yield bonds close to 6%. We thus recommend our clients: (1) to give preference to eurozone equities, (2) to reassess growth stocks at a reasonable price, but (3) still not to reposition on small-cap stocks. Outside Europe, we remain positive on domestic Chinese and Japanese equities.

Bonds: In credit, we are reducing the overall duration of portfolios and are positioning towards shorter maturities, also known as short duration. In that sense, we are reducing our exposure to credit risk after an impressive spread tightening. On the other hand, we are lengthening the duration of portfolios that hold mainly US sovereign bonds. Adding duration offers diversification and carry.

Risk management: For those who can, it is also possible to add convexity to portfolios by buying put options on equity indices. Volatility has dropped significantly and with a few tens of basis points, it is now possible to effectively hedge a portfolio in case of a market correction. Conversely, you will still benefit from exposure to risky assets if equity markets continue rising.

In conclusion, it is time to be a bit more cautious and favour the carry trade once again. The interest rate environment is evolving so fast that it offers arbitrage opportunities to build highly diversified, robust portfolios that are much less risky than in periods of zero interest rates. The rentier can breathe again!

Past performance is not a reliable indication of future return and is not constant over time. These examples are not investment recommendations

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