بنك أبوظبي التجاري
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US Treasury: best hedge in troubled times

The purpose of this note is to reiterate our bullish call on US long-term Treasuries. This call has been in place since May 2014.

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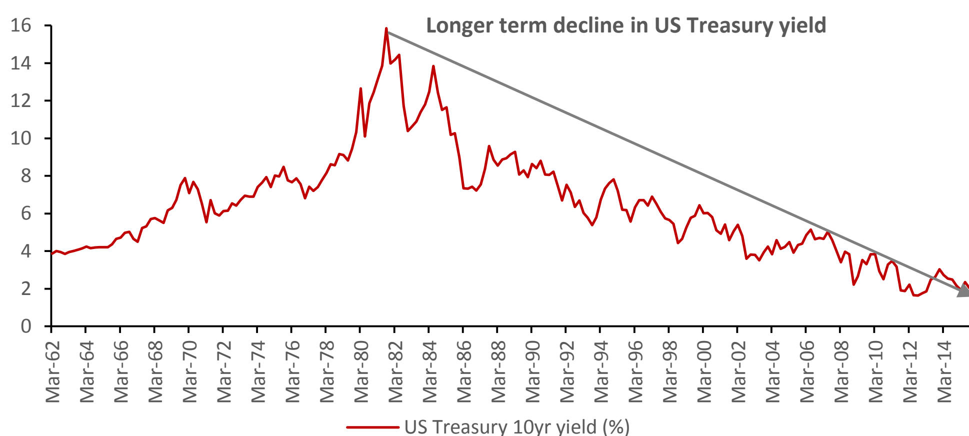
- **Post Great Financial Crisis deflationary factors – specifically historically unprecedented high debt levels and ageing populations in advanced economies - are still at play**
- **Large global overcapacity in commodity and industrial sectors is likely to keep inflationary forces at bay**
- **Muted global growth, including US growth, is unlikely to create any demand side pressure on inflation**
- **Fed to be more patient and any small hike this year is likely to flatten the yield curve, rather than pushing the entire curve higher**
- **US Treasuries provide a good risk hedge during market jitters**
- **Although our recommendation of US Treasuries is mainly as a risk hedge, it could potentially give a decent return to investors in case of a deeper than currently anticipated slowdown in global economic growth**

A massive rally over the last three decades

Better inflation management and improved policy instruments over the last decades have been able to bring the nominal interest rate systematically lower in the US. US Treasury yields, though periodically up during periods of rising inflation and tightening monetary policy, have largely trended lower since 1982. Deflationary factors – specifically historically unprecedented high debt levels and aging population - in the post Great Financial Crisis period are at play as reflected through over-capacity in commodity and industrial sectors globally. Slower than potential GDP growth globally and in the US particularly as well are not supporting inflationary dynamics. In such an environment, it is unlikely that the Fed would hike rates significantly from the current level so that the longer side of the yield curve will get affected. The current level of US Treasury 10yr below 2% raises question about how far it can go further down. The answer lies in the comparison of sovereign yield levels in other major developed countries. The level of sovereign 10yr yields in the US, the UK and Germany were similar over the last few decades before they diverged in 2013. The current lower Germany and Japan's sovereign yields do provide a sense of where US Treasury yield could go if we see slower than anticipated growth in coming quarters.



Source: Bloomberg

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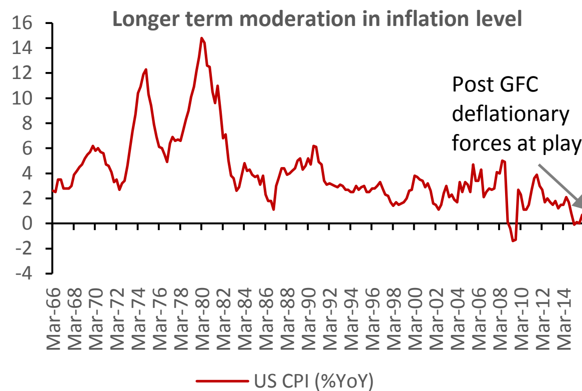
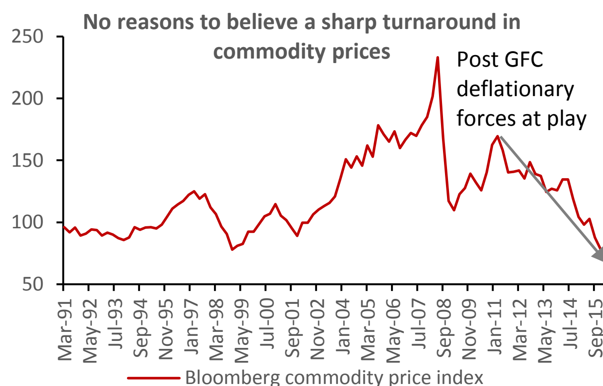
Inflation is not coming back in the near term

Central banks in most developed countries and in the US particularly have been able to control inflationary pressure over the last three decades. The volatile nature of inflation during the 1960s and 1970s no longer exists. In the post Great Financial Crisis of 2008-09 periods, however, central banks are struggling, on the other side, to prop-up inflation in a leveraged world. The introduction of Quantitative Easing (QE) and zero policy interest rates have not been able to sustain inflation at a desired level. More recently, the introduction of negative interest rates by central banks of larger economies such as the Eurozone and Japan, (though in some countries such as Switzerland and Sweden it was already in place for over a year) seems also unlikely to have any meaningful impact on the price dynamics.



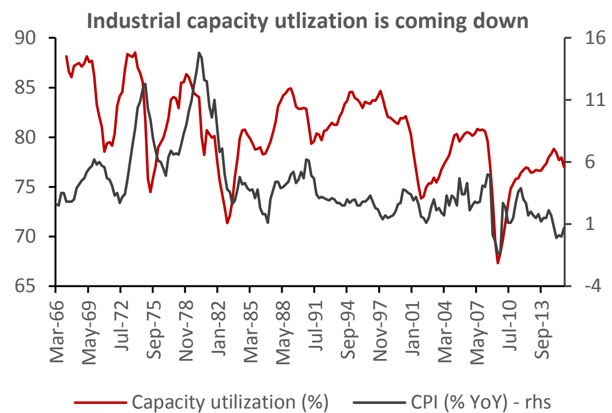
Source: Bloomberg

The deflationary forces are not only domestic due to continuing slack in labour markets in major economies (including also, we believe, in the US). Global over-capacity especially in the broader commodity sector continues to play a role major role too. The International Monetary Fund expects commodity prices (commodity price index including both fuel and non-fuel price indices) to decline by another 4% in 2016 with only a modest recovery in 2017.



Source: Bloomberg

The decline in the global trade over the last one year has created spare capacity in industrial sector across the globe, including the US. Capacity utilization has been easing for more than a year now while forward looking indicators, such as ISM manufacturing, remain in the contractionary zone. Industrial capacity utilization, being a good leading indicator for inflation, also paints a moderate picture for inflation in coming quarters.



Source: Bloomberg

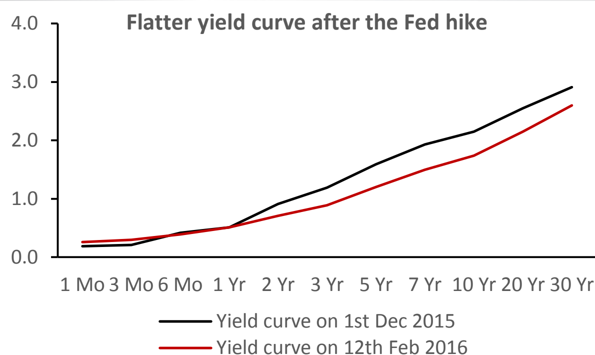
Growth remains at best sluggish

Most growth indicators are pointing to a modest economic growth outlook globally, including the US. Moderate economic growth, lower than the potential growth rate, is unlikely to exert any inflationary pressure in coming quarters.

Source: Bloomberg

Fed is likely to be more patient

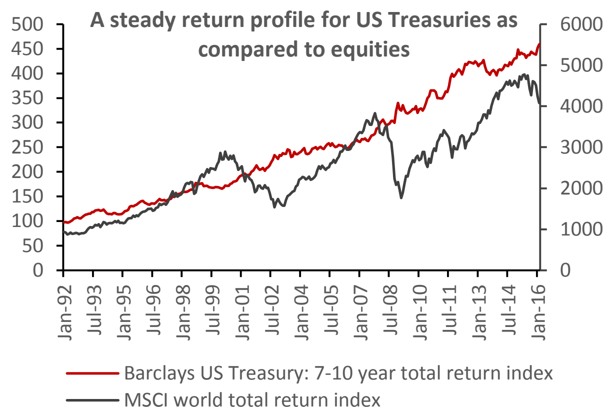
In such an environment of lower growth and inflation, the Federal Reserve is unlikely to push the policy rate higher in any significant way in the foreseeable future. If the latest response from the market on the rate hike by the Fed in December is any signal, any further hike (which we doubt in 2016) would only result into flattening yield curve, rather than the entire curve shifting up.



Source: US Treasury

Good risk hedge in current environment

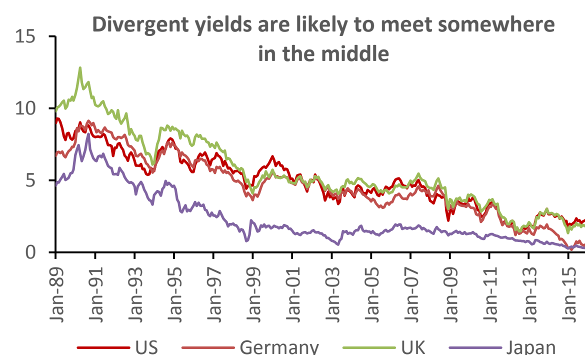
In an environment where we are underweight on global equities (as communicated in our earlier reports), we believe that US Treasuries provide a good risk hedge. The chart below shows that bond indices do not suffer large losses like equity indices. On a long term basis, the total return from the Barclays US Treasury index (7-10 years) is not very different from the MSCI World total net return. More recently, in the last two months, the former has significantly outperformed the later in terms of return.



Source: Bloomberg

There is potential for capital gains

Although our recommendation of US Treasuries is mainly as a risk hedge, it could potentially give a decent return to investors in case of a deeper than currently anticipated slowdown in the global economic growth. The US Treasury 10year yield below 2% raises questions in many investors' mind about how low the yield could further decline. The answer lies in level of sovereign yields in many other developed countries. We have taken sovereign 10year yields from four major countries (US, UK, Germany and Japan) in the chart below where three (the first three) have historically moved very close to each other before the German yield started diverging from rest of the pack and Japanese yields moved further down since 2013. If history provides some guidance, these yields should converge at some point. We believe that the convergence would likely be somewhere in the middle which should provide capital gains on US Treasury positions.



Source: Bloomberg

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. *Bloomberg*
2. *Wall Street Journal*
3. *RTTNews*
4. *Reuters*
5. *Gulfbase*
6. *Zawya*

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