Global Matters Weekly

19 February 2024

MOVErs and shakers

by Alex Harvey, CFA

As someone with a tracker mortgage I'm taking a keen interest in the widely anticipated cuts in the bank base rate that are expected to materialise over the course of this year. I am (perhaps) fortunate to have fixed-rate debt elsewhere – so my aggregate cost of funding has remained manageable - but nonetheless, like most homeowners, my monthly costs have risen in recent years as interest rates (and utility bills, service charges, insurance etc) have gone up. I even read this morning that the average cost of a pint of beer in London is now £5.90. Please tell me where, as I'm sure I pay more than that!

Whilst UK base rates are of most direct relevance to me, you won't be surprised to know that the US 'risk-free' rate sets the global benchmark for lending. In recent years, the Federal Reserve's anti-inflationary policy shift has stirred rates markets from their Quantitative Easing (QE)* induced slumber. Readers may be familiar with the 'VIX' index – sometimes called Wall Street's 'fear gauge' - a measure of future expectations of US equity market price volatility. In US bond markets, the equivalent measure is called the MOVE** index, and without getting too technical, it averages the one-month forward implied price volatility of 2, 5, 10 and 30-year treasury bond options. A higher number means higher expectations for bond price (and inversely yield) volatility; a low number suggests more benign forward price risk, although other factors such as geopolitics, liquidity and leverage all play their part. [Note there is also a lesser-known currency volatility index cousin – Deutsche Bank's 'CVIX' index – calculated as the arithmetic average of 3-month implied volatility for all the major currency pairs].

Our job as managers of our clients' investments, is to balance what markets are pricing, against what is a reasonable expectation of the eventual outcome. Are we paying a fair price for the market's embedded return? A little over one month ago, following a pivot in the Fed's language late last year, US rates markets had moved to price in a whopping seven rate cuts of 25bps each (a total of ~175bps) by the end of 2024. Yet at the same time, US equity markets have been punching 'Magnificent' new highs, jobs growth is on fire and the housing market – key to US consumers' financial health - remains robust.

Ordinarily, Fed rate cuts of that magnitude would accompany a sharp slowdown in growth, but the US economy appears in rude health, recording real GDP growth of 2.5%1 for 2023, of which the Q4 advance data – released in late January - contributed 3.3% quarter on quarter on an annualised rate basis (versus 'only' 2% consensus expectations). So how do we square those deep implied rate cuts with a seemingly vibrant and resilient economy, that is arguably still running hot? Well, we no longer need to.

In recent weeks some sense has come back into bond markets, which in our opinion had run too hard, too fast. The latest Fed 'dots' – the projected year end and longer-term expectations for the Fed Funds target rate made by each of the Federal Reserve committee members – has a median year end rate of 4.625%***. Fed fund futures are now pricing ~4.6% for the month of December – up from 3.75% just five weeks ago; an implicit tightening. Of course, just because the Fed and the market are more aligned does not mean either will be correct, but when prices become so heavily discounted and are at odds with the fundamentals, opportunities can be presented to lean against the embedded pricing. The margin of safety is greater, should the implied outcome not eventuate (and last year's much anticipated US slowdown, which never materialised, is another good example).

In the second half of last year US rates surged higher. At the same time US CPI (the consumer price index of inflation) was falling. This meant that inflation adjusted bond yields were rising even faster. Consequently, late last year real yields – a measure of forward-looking inflation adjusted bond yields – had breached 2.5% across the US yield curve (from as low as negative 2% in late 2021). In October you could buy the 5 year 'TIPS' (Treasury Inflation Protected Security) and earn a real return (after inflation) of 2.6% per annum – that's almost 14% compounded over 5 years. With the coupon and principal of that bond linked to US CPI, that return is guaranteed if you hold the bond to maturity. At Momentum this was a strong signal for us to add to our already increasing bond allocations, and on 18 October we purchased nominal treasury bonds at a yield of 5.25%. Two months later, in the week before Christmas, we trimmed that back at a yield over 100bps lower for a near 16.5% holding period return.

It is unusual for us to be that active with our tactical positioning, over what is a relatively short timeframe. Our time-tested asset allocation process revolves around longer-term relative value opportunities. But when the market MOVEs, you need to MOVE with it. And it might just be time to MOVE back in.

* Quantitative Easing (QE) – the post GFC policy of central banks to purchase government bonds to lower benchmark yields and funding costs for households and corporates (and governments)
** Merrill Option Volatility Estimate' – although in 2019 Bank of America Merrill Lynch sold the index to the Intercontinental Exchange 'ICE')
*** And a range from 3.875% to 5.375% - that higher number being where we are today at the mid point of the current lower and upper Fed target range

Sources
1 https://www.bea.gov/news/2024/gross-domestic-product-fourth-quarter-and-year-2023-advance-estimate

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