

# GLOBAL MARKETS FORUM

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## Q&A- Treasury yields "too low," short duration best in HY corp debt: Michael Contopoulos, Richard Bernstein Advisors



U.S. Treasury yields have likely already bottomed and will rise as the Federal Reserve begins to "talk about talking about" tapering its asset purchases, **Michael Contopoulos, Director of Fixed Income at Richard Bernstein Advisors** told the Reuters Global Markets Forum on Monday, June 14.

"Treasures' (yields) are too low if you think the Fed tapers at some point and believe at all in U.S. economic growth," he said.

Additionally, he sees good opportunities in short maturity U.S. high-yielding corporate bonds, as the market is currently overly pricing in the risk of defaults.

Following are edited excerpts from the conversation:

**Q: As it's Fed week, what are you expecting from them this Wednesday, particularly on any tapering announcements?**

A: I think the Fed has been very deliberate with their communication on tapering, and this week is likely to be a continuation of what we have already begun to see -- a slow process of breaking it to the world that tapering is coming. We don't think there will be a grand announcement, but rather just more Fed officials discussing that the time is coming to communicate a plan. We do think that step one was announcing the roll-off of their corporate bond holdings.

**Q: How do you see this playing out in treasuries?**

A: Treasuries are too low if you think the Fed tapers at some point in the coming quarters and believe at all in U.S. economic growth. There are four key factors that go into 10y yields: Fed Funds rate, size of Fed balance sheet relative to GDP, CPI and leading economic indicators. Three of those four will be supportive to higher rates in the next 12 months and at that point we will be a year closer to hikes. So, in our view, rates have likely bottomed here. As timing for tapering becomes more clear, 10y likely moves up. I would expect more detailed announcement come Jackson Hole or the September FOMC (Federal Open Market Committee).

**Q: Was last week's squeeze of treasury shorts premature, then?**

A: I think you hit the nail on the head. Last week's move was a squeeze. A lot of short positioning out there finally was washed out. That started with the last jobs number really. We said back in the winter (that) rates are now in the "show me" phase. A few solid reports are not enough to cause a sustained move higher in yields given the selloff all the way from the depths from last year. Instead, the market needs to a) see consistently high jobs and inflation numbers that beat consensus, b) get a stronger timeline on tapering and/or c) get a large fiscal -- infrastructure -- package. At least one if not two or all three, should materialize over the back half of 2021.

**Q: Do you think communication on a timeline will be clear enough to avoid another taper tantrum?**

A: I do. Remember, Chair Bernanke really let the cat out of the bag during a testimony to Congress back in 2013. It was completely impromptu and unexpected, and completely caught the market by surprise. Today's communication has been so deliberate its almost painful. That doesn't mean we won't see higher rates, but I don't think you're likely to get the same kind of reaction as eight years ago. The market is anticipating taper -- anticipating some kind of announcement of it in August or September. Just completely different than the tantrum.

**Q: When it's time, how do you see the Fed unwinding asset purchase? Do you think they could start by phasing out MBS (mortgage-backed securities) purchases?**

A: I think phasing out MBS first makes a lot of sense, though I'm not so sure the Fed will get that granular with their plan. At the end of the day this was not a housing crisis and purchasing MBS was probably never necessary. But they took the playbook from the GFC (great financial crisis) and went with it. So, although I think phasing out MBS would make a ton of sense given where the housing market is today, my suspicion is it will be a set dollar amount over 12 months, and they'll run down purchases on both.

**Q: What are your thoughts on the Fed unwinding its corporate bond holdings? Was the timing right and do you think it matters much in terms of corporate bond spreads?**

A: No. I don't think it matters at all for Corporate Bond Spreads. The amount the Fed holds is nearly equivalent to a large new issue on any given day. So, there should be no disruption at all to the corporate bond market. I understand there are concerns about signalling, but the fact that they are unwinding has nothing to do with their future willingness to purchase. So, no impact at all. In terms of timing, I think it's a way to clean up the house a bit before announcing tapering. Hard to justify these holdings when they want to signal that the economy and capital markets are strong enough to wind down purchases.

**Q: With the expected increase in interest rates, do you see companies reducing bond issuance this year?**

A: Yes. We think so. There was so much issuance last year, and so much cash on balance sheets, it only makes sense to issue less this year. When you combine that with huge increases in EBITDA, we think 2021 and 2022 can lead to one of, if not the largest, repairs in corporate balance sheets in history.

**Q: So, given that, what specific sectors of the corporate bond market make the most sense in a portfolio now?**

A: More than sector we think there are parts of the curve that make a ton of sense. In particular, long maturity IG offers an attractive yield and on a spread basis, particularly to swaps, and could still tighten substantially. So, to the extent you can express a spread position, we like long maturity IG to swaps.

In high yield, it's the opposite. We actually think there is a lot of value in short maturity U.S. high yield. Defaults are plummeting - we think as low as 1.5% over the next year- and short maturity HY is pricing in too much default risk given our expectations.

**Q: To what extent do you think the extraordinary UST performance relative to Fed/inflation outlook is due to overspill demand from overseas funds starved of other G4 government safe assets?**

A: I think there is some truth to the strong foreign demand story. However, they tend not to be the key drivers of treasuries and you have to look on an FX (forex) hedged basis. From that vantage point, treasuries do look relatively attractive, so it makes sense they are buyers. Having said that, I think we've seen that the foreign buying base can't be relied on and when the Fed decides to taper and eventually exit the market, the supply likely overwhelms private demand at current yields.

**Q: Will the first of the 800 billion euros of Recovery Fund issues this week affect that calculus in any way?**

A: I wouldn't think so. We deal with knowns and unknowns. The unknown is the Fed and what their communication strategy will be. Expect that to be the dominant driver of yields for the week.

**Q: Any final thoughts for us before we close?**

A: I think the biggest thing is not to get bogged down in the day to day. For most investors capturing the big macro themes matter most. So, ask yourself -- is the world looking better or worse -- better. Are the trends in growth, inflation and Fed involvement going up or going down -- up for growth and inflation, down for fed involvement. Once we capture those big themes, we can begin to draw conclusions. And it seems to us that means higher rates, positive credit spread environment and likely global, not just U.S. opportunities.

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