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January 30, 2018

THE PAIN TRADE SIGNALS FROM THE BOND MARKET

Highlights

As the 10-year Treasury yield staged an upside breakout at 2.6%, and luminary investors such as Bill Gross, Jeff Gundlach and Ray Dalio have declared the bond bull to be over, I have a number of key questions for the markets. First and foremost, "What's the pain trade?"

We find that the market is poised for a bond market rally, accompanied by a corrective period in equities, and a USD rally. While we have no way of precisely timing the inflection point, investors should be aware of the looming risks in the latest FOMO equity stampede.

The Pain Trade Signals from the Bond Market

As the 10-year Treasury yield staged an upside breakout at 2.6%, and luminary investors such as Bill Gross, Jeff Gundlach and Ray Dalio have declared the bond bull to be over, I have a number of key questions for the markets. First and foremost, "What's the pain trade?"

Exhibit 1: 10-year Treasury Yields Upside Breakout

Source: Stockcharts

How these questions are resolved will also have important implications for the future direction of stock prices.

Which Signal Do You Believe?

One of the most important question for the bond market is: "Which signal do you believe?"

As the chart below shows, past tests of the downtrend in 10-year Treasury yields has coincided with yield curve inversions. The only exception was in 1994-1995. Even then, that episode saw the yield curve flatten dramatically

Exhibit 2: 10-year Treasury Yields and Yield Curves

Source: Stockcharts

Fast forward to 2018. The yield curve is flattening, but nowhere near inversion. The 2-10 spread has been volatile and it has been bouncing between 50 bp and 60 bp. The 10-30 spread flattened to 25 bp, which is a cycle low, but neither the 2-10 nor the 10-30 spreads are inverted.

Here is the critical question: "Do you believe the signal from the upside breakout in yield, or the yield curve?"

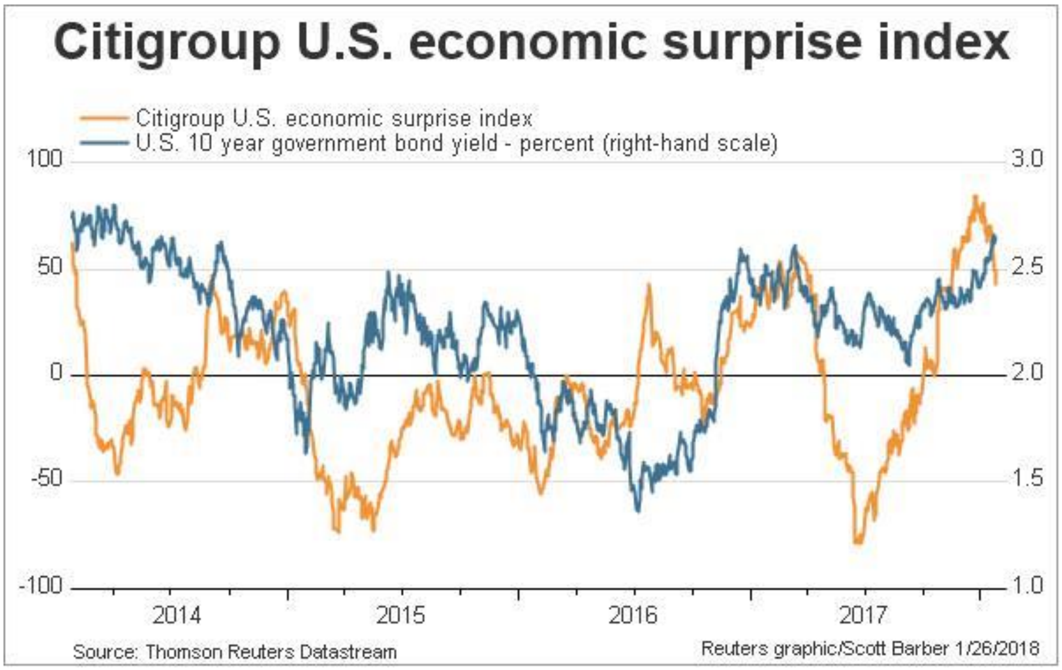
If you believe the yield curve is flashing a false signal, and it should really be inverted because central bankers have distorted its shape with their endless QE programs, then the economy is nearing recession and investors should therefore adopt a risk-off posture in their portfolios.

On the other hand, if you believe in the validity of the yield curve signal, which indicates that the economy is far from an inversion and therefore a recession warning, the upside breakout is a response to rising inflationary expectations, then the bond market is indeed entering a bear market.

A Lurking Growth Disappointment?

Here is one way to resolve that conundrum. Experienced bond investors understand that bond yields are correlated with growth expectations. As the chart below shows, 10-year Treasury yields has been tracking the Citigroup U.S. Economic Surprise Index (ESI), which measures whether macroeconomic releases are beating or missing expectations.

Exhibit 3: Citigroup U.S. Economic Surprise Index Correlated with Bond Yields

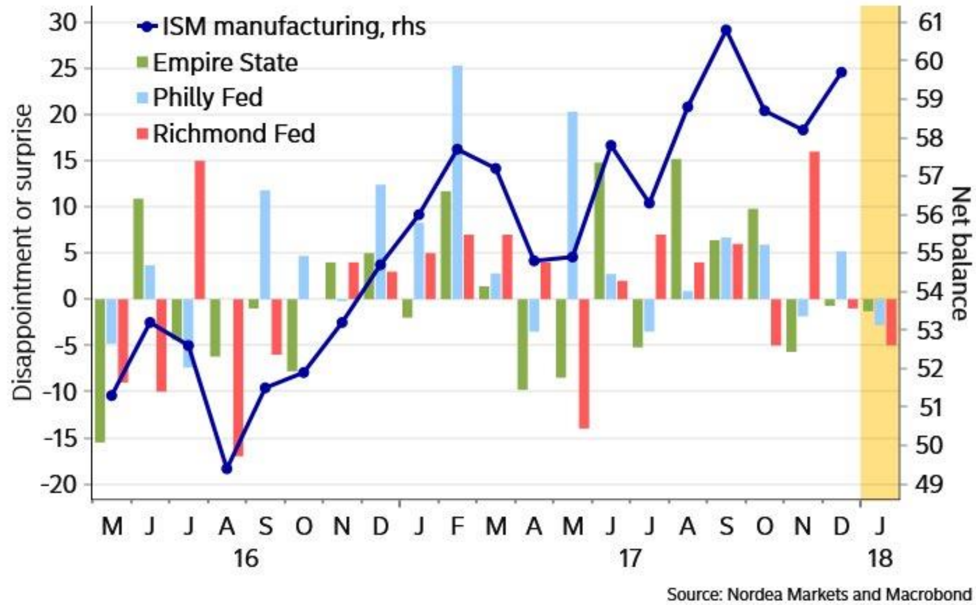


Source: Datastream

Here is another important question: "As economic data has disappointed and the ESI fallen in the last few weeks, why haven't bond yields followed?"

Even before the Q4 GDP miss last Friday, Nordea Markets pointed out that regional Fed indices were coming below expectations.

Exhibit 4: January Regional Fed Indices Have Missed Expectations



Source: Nordea Markets

Last Friday, the headline Q4 GDP came in at 2.6%, which was well below Street expectations of 3.0%, the Atlanta Fed's GDPnow nowcast of 3.4% and the New York Fed's nowcast of 3.9%. Moreover, the GDP Deflator came in ahead of expectations, indicating rising inflationary pressures. That's growth bearish, right?

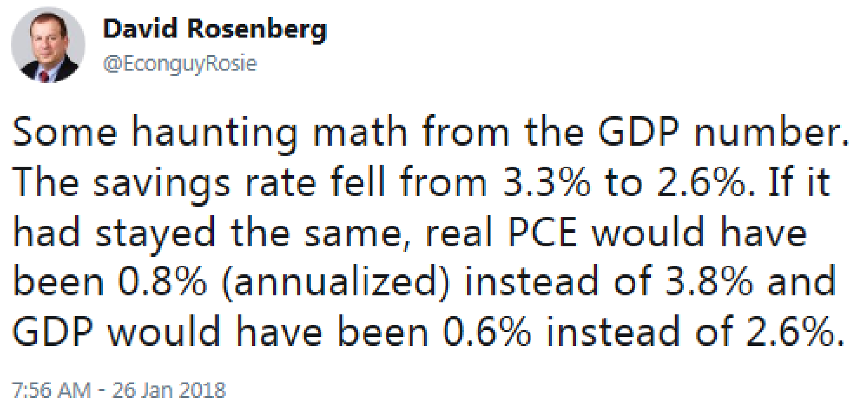
There was, however, some debate about the underlying strength of the American economy based on the internals of the GDP report. Ryan Detrick of LPL pointed out that growth was actually quite good once you strip out the inventory and trade effects.

Exhibit 5: The Q4 GDP Good News

Source: Twitter

David Rosenberg, by contrast, chose to focus on the negatives.

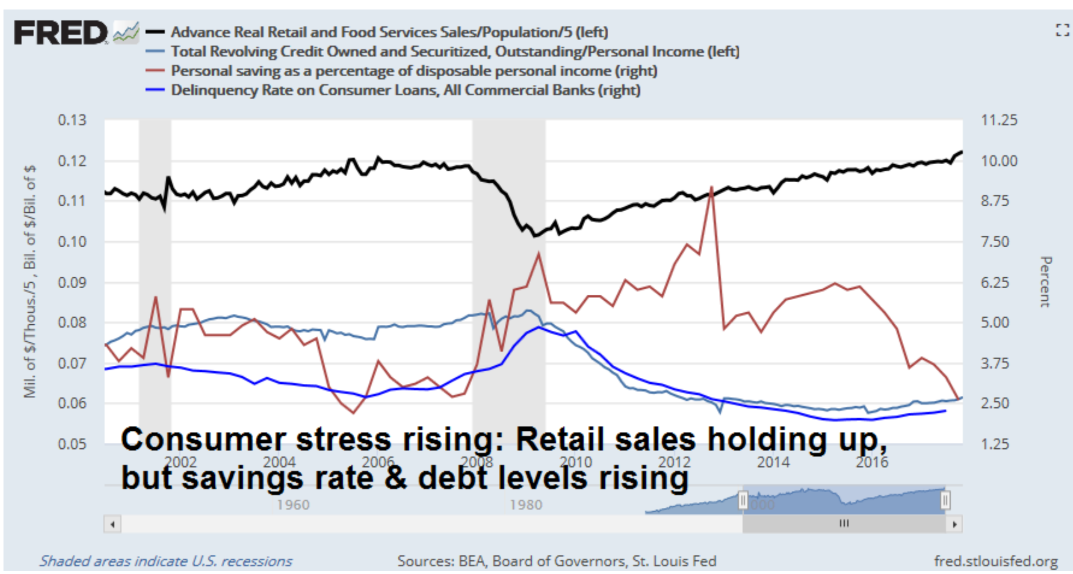
Exhibit 6: The Q4 GDP Bad News



Source: Twitter

Rosenberg is correct to highlight the vulnerability from the falling savings rate. Consumer finances are becoming stressed. While retail sales (black line) are holding up, they have been sustained by falling savings rates, rising debt levels and rising delinquency rates on loans.

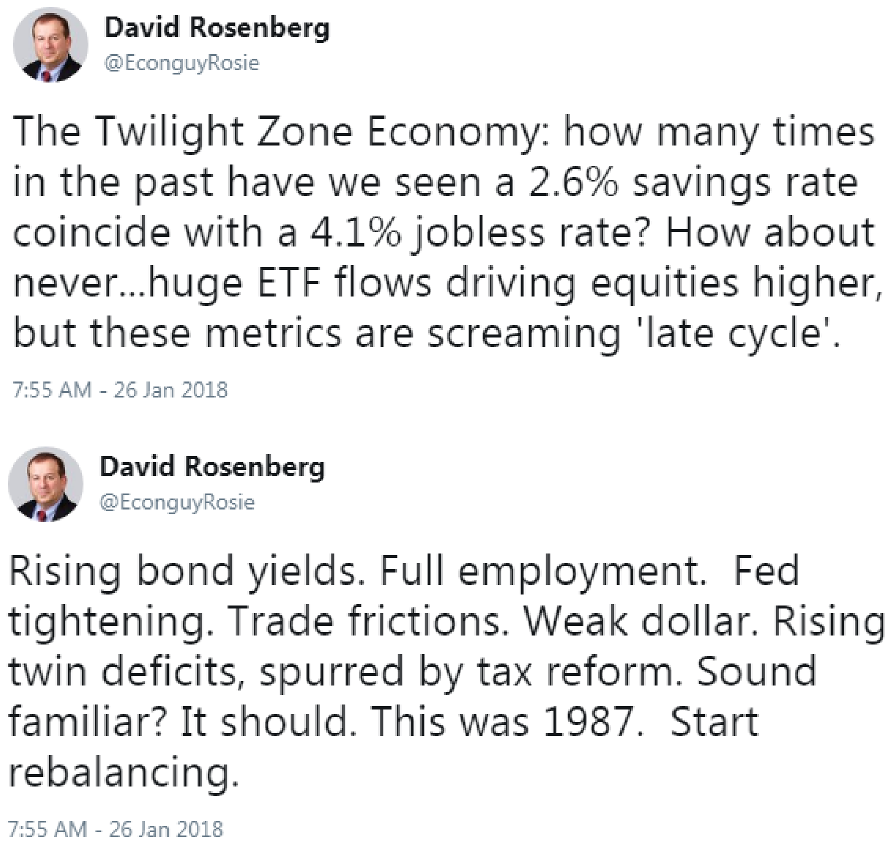
Exhibit 7: Household Finances Stress Increasing



Source: FRED, Federal Reserve Bank of St. Louis

Rosenberg came to an ominous conclusion for stock and bond prices.

Exhibit 8: The Really Q4 GDP Bad News



David Rosenberg
@EconguyRosie

The Twilight Zone Economy: how many times in the past have we seen a 2.6% savings rate coincide with a 4.1% jobless rate? How about never...huge ETF flows driving equities higher, but these metrics are screaming 'late cycle'.

7:55 AM - 26 Jan 2018

David Rosenberg
@EconguyRosie

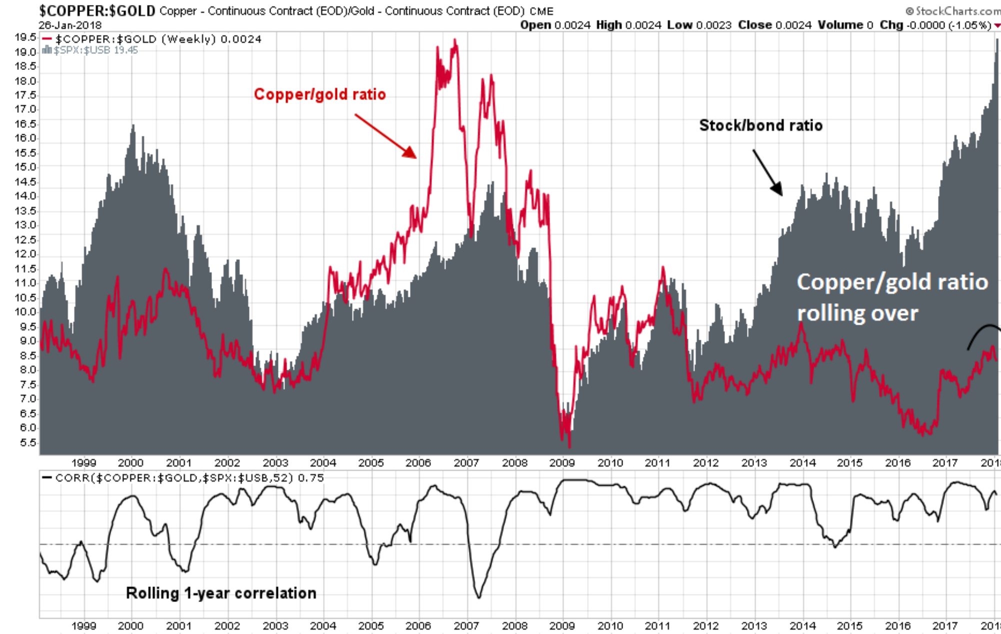
Rising bond yields. Full employment. Fed tightening. Trade frictions. Weak dollar. Rising twin deficits, spurred by tax reform. Sound familiar? It should. This was 1987. Start rebalancing.

7:55 AM - 26 Jan 2018

Source: Twitter

Who's right? There are signs that the market may see a downside growth surprise in the near future. The following chart shows the copper/gold ratio (red line), which is a highly sensitive indicator of cyclical growth, and the stock/bond ratio (grey bars), which measures risk appetite. The bottom panel shows the rolling one-year correlation of these two series, which validates the effectiveness of the copper/gold ratio indicator. As the chart shows, the copper/gold indicator is starting to roll over, which is a signal that global growth momentum may be stalling.

Exhibit 9: The Copper/Gold Ratio Signaling a Slowdown



Source: Stockcharts

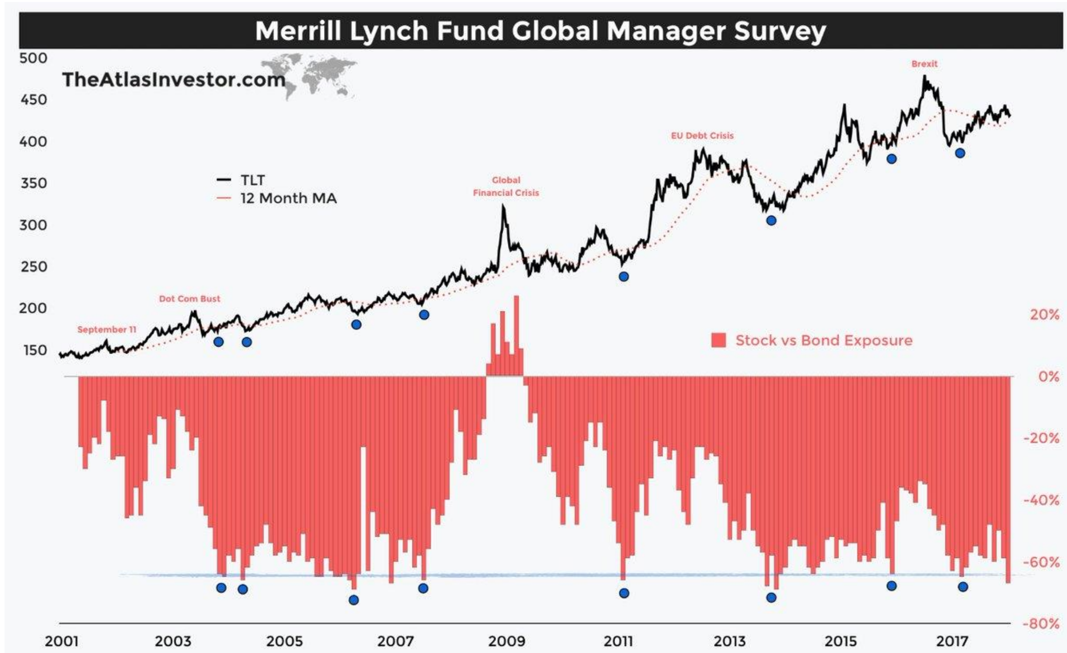
Nautilus Research also found that the stock/bond sentiment is at an extreme. Such conditions have historically signaled bond market rallies and weak stock markets.

Exhibit 10: A Stock/Bond Sentiment Extreme

Source: Nautilus Research

Tiho Brkan also found a similar bullish bond market signal based on the stock/bond sentiment of the BAML Fund Manager Survey.

Exhibit 11: BAML Fund Manager Survey Sentiment Favours Bond Market Rally



Source: Tiho Brkan, The Atlas Investor

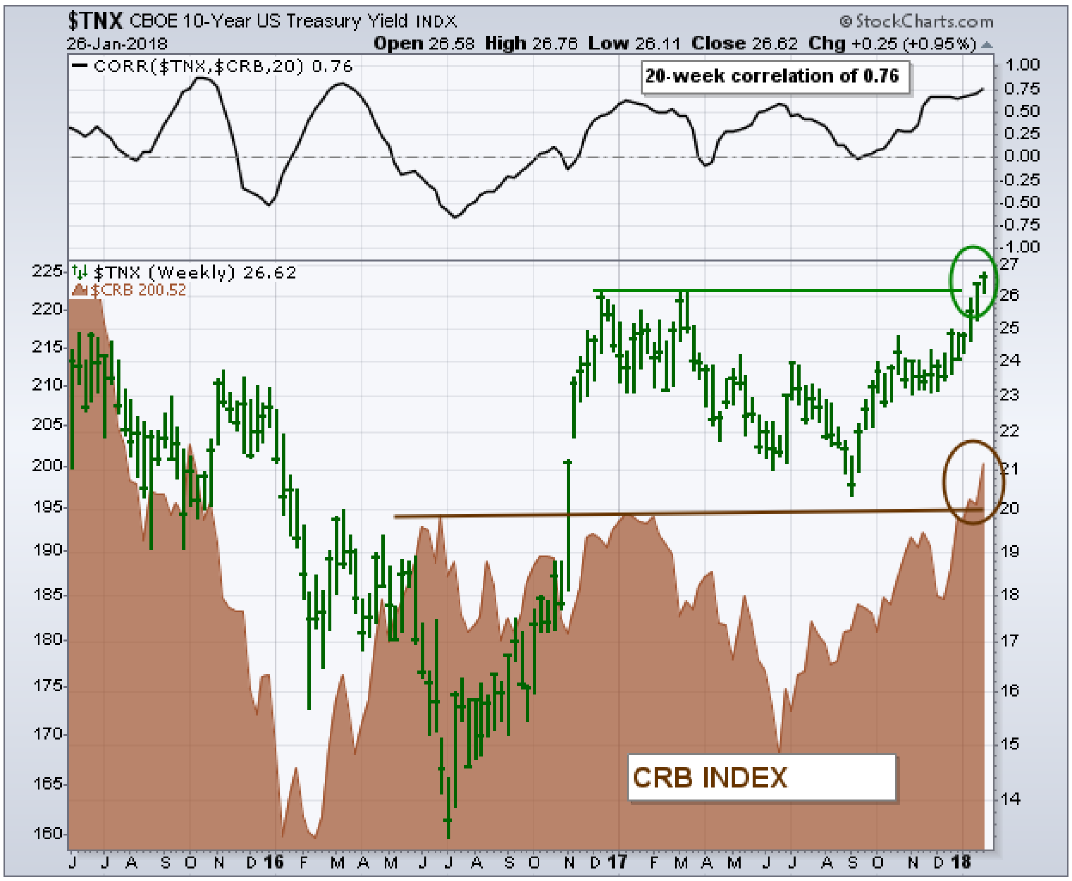
After the latest upside yield breakout and everyone loudly proclaiming the death of the bond bull, it appears that bond prices are poised for a rally based on disappointing growth expectations. That's one pain trade the market is setting up for. Such a scenario is equity bearish. In light of the recent market melt-up, we remind readers of Bob Farrell's Rule #4: "Parabolic markets go further than you expect, but they don't correct by going sideways."

Buy When Bond Blood Run in the Streets?

Admittedly, buying bonds and interest-sensitive issues today is like trying to catch a falling knife. However, there are a number of other important investment implications to the bond rally thesis, and there are opportunities in crowded extreme positions where the proverbial blood is running in the streets (another pain trade).

The following chart provides a graphical illustration of the correlation between yields and commodity prices.

Exhibit 12: 10-year Yields Correlated with CRB Index



Source: Stockcharts

The following chart shows the relative performance of interest-sensitive sectors of the stock market (top panel) and the inflation-sensitive sectors of the market (bottom panel). If bond prices were to rally, then investors should focus on buying the former and avoiding the latter. Under such a scenario, inflation-sensitive sectors such as energy, gold and mining may need more time to consolidate sideways relative to the market. Similarly, growth and momentum stocks are likely to lose their mojo and correct.

Exhibit 13: Relative Returns of Interest Sensitive and Inflation Sensitive Sectors

Source: Stockcharts

If commodity sensitive stocks were to underperform, another crowded trade that is likely to reverse is USD weakness. The latest Commitment of Traders report shows that large speculators are in a crowded short in the USD, and crowded long in the euro.

Exhibit 14: A Crowded Short in USD Index

Source: Hedgopia

The USD Index is now testing a key long-term Fibonacci support level and a rally could occur at any time.

Exhibit 15: USD Index at Fibonacci Retracement Support

Source: Stockcharts

Tactically, interest-sensitive vehicles are not showing signs of a bottom yet. While investors could take a partial position now, traders may wish to either wait for a test of support or an upside breakout of the downtrend line before making large commitments. The long Treasury bond ETF (TLT) is one example of this technical pattern.

Exhibit 16: iShares 20+ Year Treasury Bond ETF (TLT)

Source: Stockcharts

REITs are also showing a similar pattern of approaching technical support while a downtrend line defines a possible bullish breakout.

Exhibit 17: Vanguard REIT ETF (VNQ)

Source: Stockcharts

Utilities have a less well-defined downtrend, but the technical pattern is roughly the same.

Exhibit 18: Utilities Select Sector SPDR ETF (XLU)

Source: Stockcharts

In conclusion, the market is poised for a bond market rally, accompanied by a corrective period stock prices and a USD rally. While we have no way of precisely timing the inflection point, investors should be aware of the looming risks in the latest FOMO equity stampede.

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