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Glovista Global Perspectives

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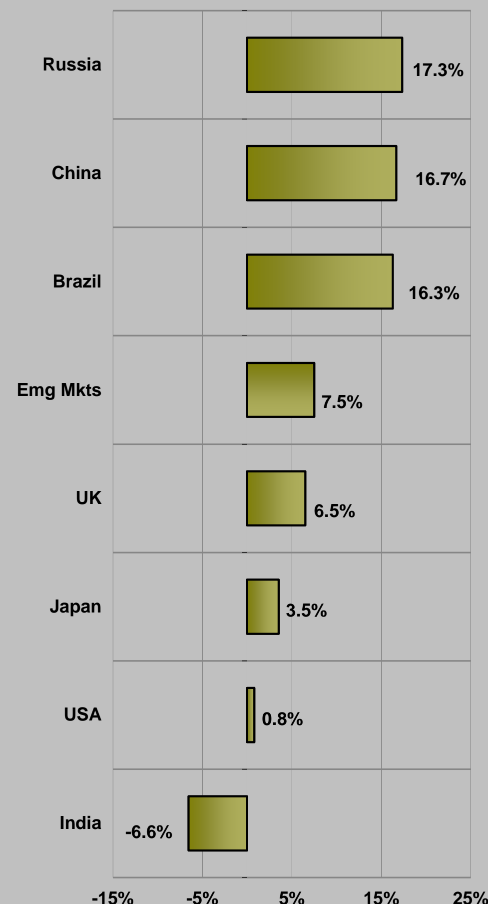
Bond Markets Sell Off Sharply in May; Glovista Cuts Equities and Raises US Dollar Long-Dated High Grade Bond Exposures; EM Asia Equities Allocation Raised Further

Over the past several weeks, developed country government bond markets have sold off sharply (Figure G-1). The sell-off has centered at the long end of the interest rate curve (Figure G-2). In our view, the recent bond market sell-off has been fueled primarily by the normalization of inflation expectations and term premium levels in Europe (Figure G-3) as opposed to market participants' reassessment of the terminal policy rate levels in the USA or Europe (Figure G-4).

The recent bond market sell-off carries important global macro and market implications. The rest of this monthly column addresses some of these implications. These range from the direction of the US Dollar to the heightened potential for negative price pressures impacting risk markets, including equities, commodities and credit. The potential for said pernicious price pressures on risk markets is increased by growing concerns over an extended period of anemic productivity growth in the developed world.

Country-wise Monthly Performance in USD terms (April 2015)



Source: MSCI & Bloomberg

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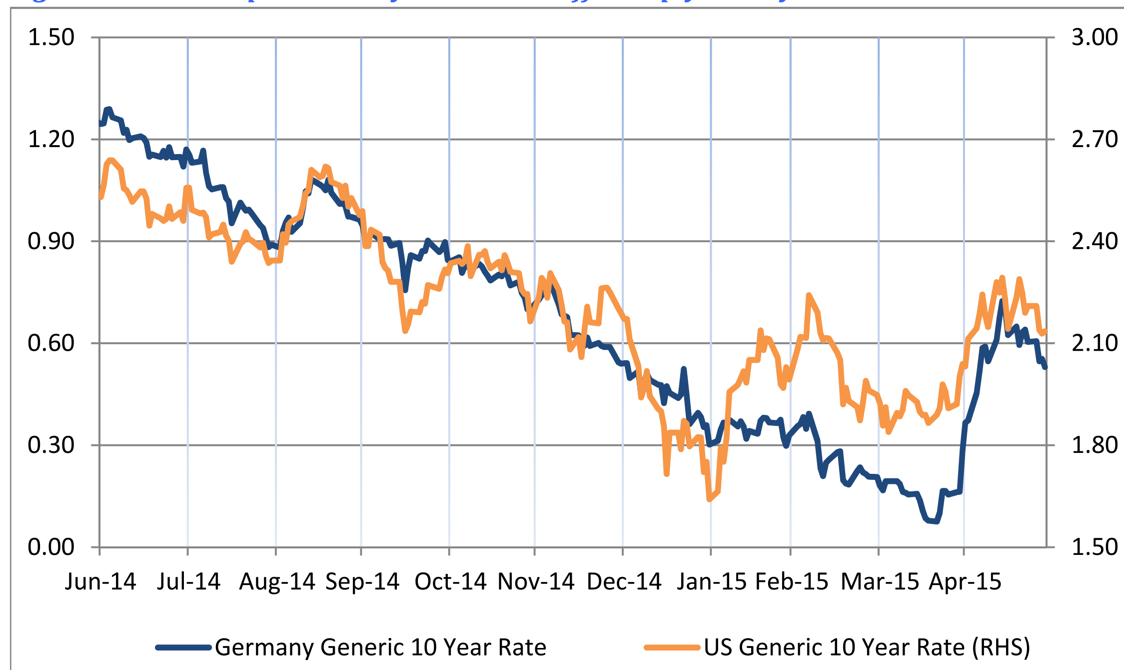
S&P500 Monthly Sector Performance – April 2015

Sectors	% Change	FY1 PE Ratio
Energy	6.56%	32.91
Materials	3.07%	18.37
Industrials	-0.08%	16.34
Cons Disc	-0.09%	19.77
Cons Stap	-0.97%	20.12
Technology	2.28%	16. 81
Healthcare	-1.41%	17.88
Financials	0.08%	14.29
Utilities	-0.49%	16.51
Telecom	4.68%	13.95
S&P500	0.85%	17.71

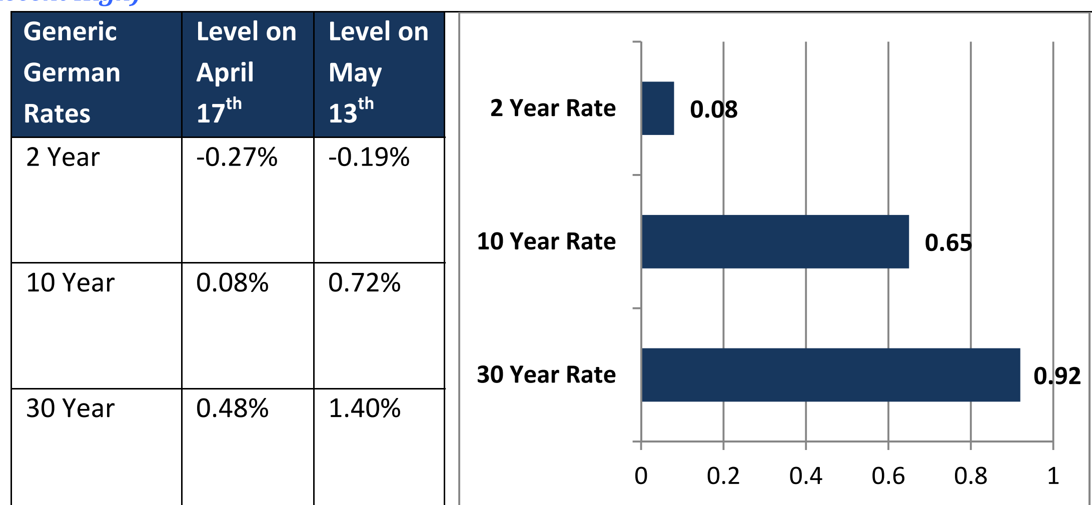
Source: S&P

Figure G-1. Developed Country Bonds Sell Off Sharply in May



Source: Bloomberg

Figure G-2. Recent Bond Market Sell-Off Led by Spike in Long-Term Bond Yields (Table Below Outlines the Changes in Yields Across the German Curve - Between Recent Low and Recent High)



Generic German Rates	Level on April 17th	Level on May 13th
2 Year	-0.27%	-0.19%
10 Year	0.08%	0.72%
30 Year	0.48%	1.40%

Source: Bloomberg

Selected Macro and Market Implications Likely to Result from the Ongoing Bond Market Sell-Off Period

In our view, the recent bond market sell-off carries potentially significant macro and market implications, including the following:

- **Heightened potential for a risk-off period** to ensue across asset markets as the sharp spike in bond market volatility that has accompanied the recent market sell-off carries the potential to fuel a contagion-like effect on other asset classes for which implied volatility levels signal investor complacency (Figure G-5).

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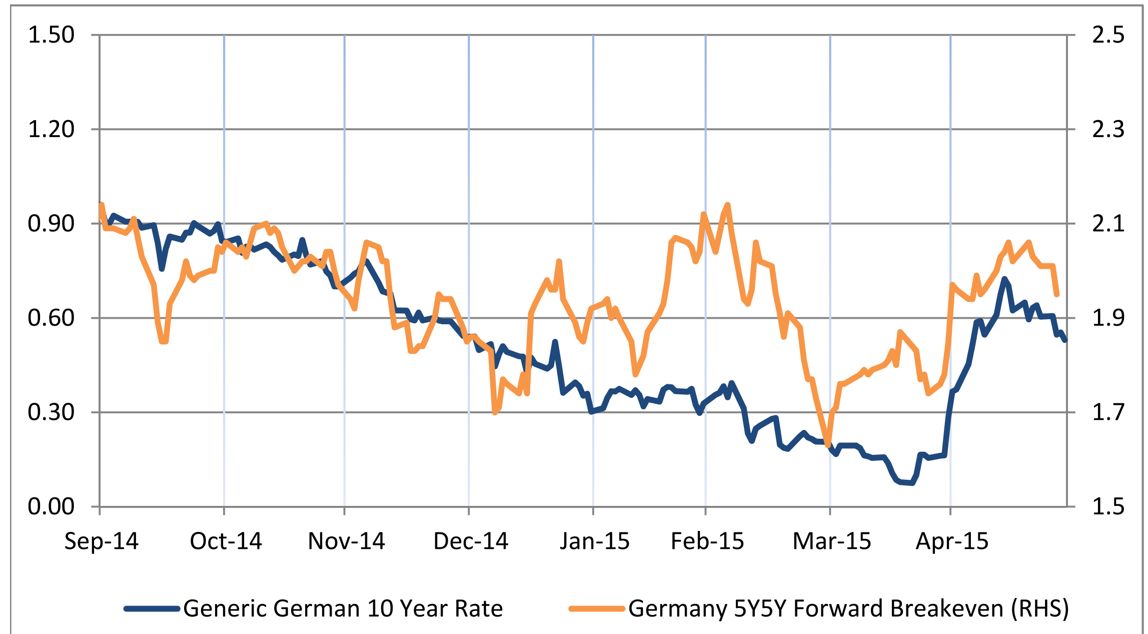
	April'15	April 'Change
Gold	1184.37	0.1%
Silver	16.1483	-3.1%
Oil	59.63	25.3%
EUR	1.1224	4.6%
JPY	119.38	0.6%
GBP	1.5351	3.6%
CHF	0.9324	4.1%
CAD	1.2077	4.8%
AUD	0.7905	3.9%
BRL	3.0145	5.7%
MXN	15.3505	-0.6%

Source: Bloomberg

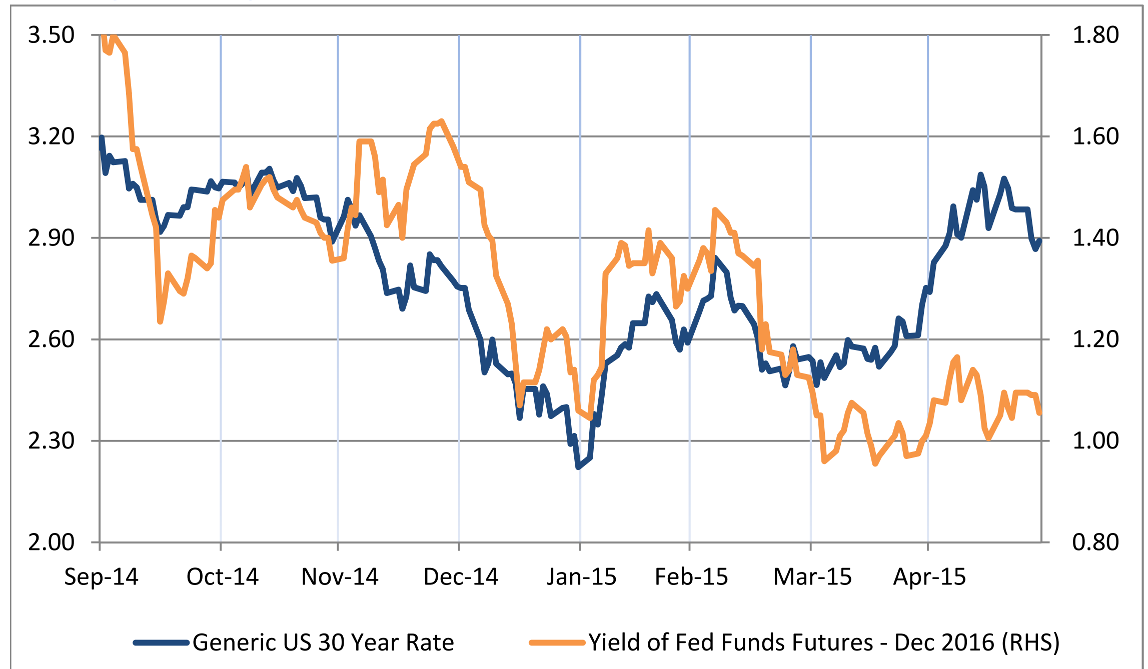
"…the recent upturn in relative economic momentum between the USA and Europe after a multi-month long period of relative strength for Europe versus the USA may reinforce the case for a resumption of the US Dollar bull trend."

Figure G-3. Rise of Inflation Expectations Accompany Sharp Rise in 10 year German Bund Yields during Recent Sell-Off



Source: Bloomberg

Figure G-4. Market Expectations of Terminal US Federal Funds Policy Rate Remain Unchanged Throughout Recent Bond Market Rout



Source: Bloomberg

- **Potential for a near-term resumption of the US Dollar bull trend** that began in July 2014 as a result of the sharp rise in market volatility which is historically positively correlated with the US Dollar index. Moreover, the recent upturn in relative economic momentum between the USA and Europe after a multi-month long period of relative strength for Europe versus the USA may reinforce the case for a resumption of the US Dollar bull trend (Figure G-6). In addition, over the past two months much of the US Dollar's overbought status (from the perspective of speculators' sentiment and positioning) has been worked off, further reinforcing the likelihood of resumption of the US Dollar's bull cycle.

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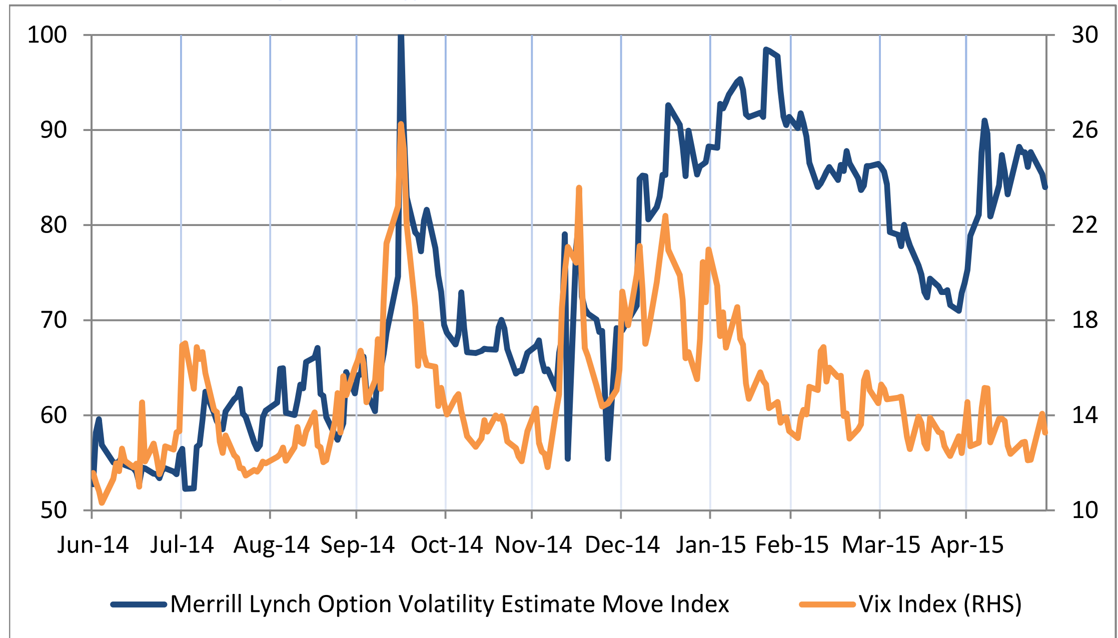
Rates	April 30th Level
1 Yr CD	0.62%
5 Yr CD	1.45%
30 Yr Jumbo Mortgage	4.06%
5/1 Jumbo Mortgage	3.6%
US Govt. 10 Year	2.03%
10 Yr Swap Spread	9%

Source: Bloomberg

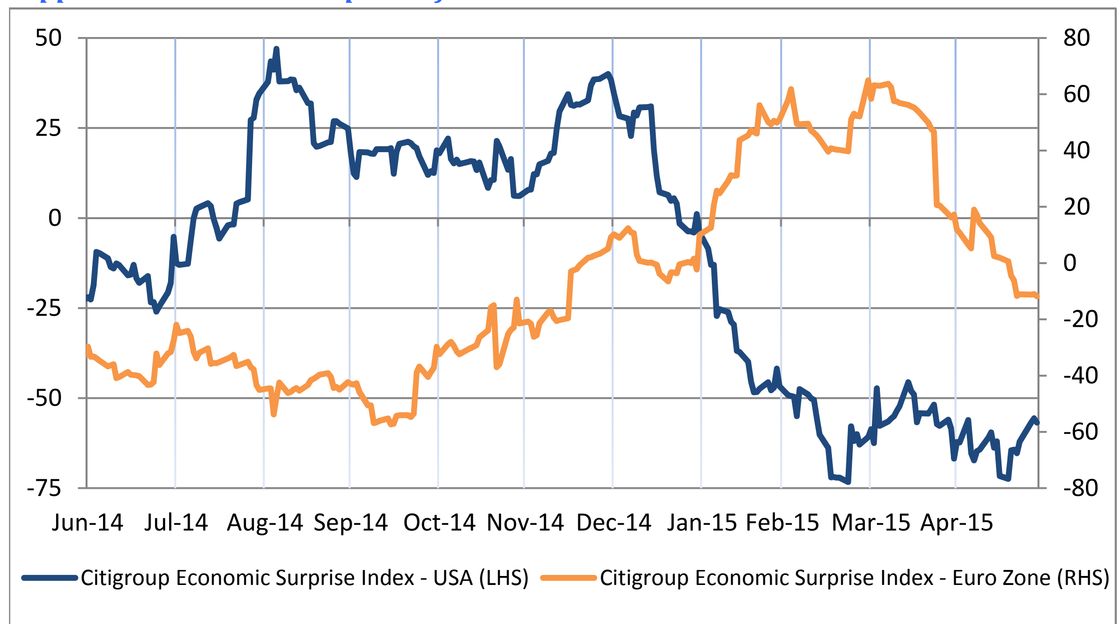
"Potential for the recent spike in long-term bond yields, if sustained, to fuel a further acceleration of downward revisions to estimates of long-term global economic growth potential as overall net indebtedness levels remain elevated."

Figure G-5. Spike in Bond Market Volatility May Fuel Catch-Up Rise in Equity Volatility, Unleashing a Risk-Off Period Across Other Asset Markets



Source: BOFA Merrill Lynch and Bloomberg

Figure G-6. US Economic Momentum No Longer Weakening versus Europe's, Likely to Support a Durable Resumption of US Dollar Bull Trend



Source: Citigroup Global Markets

- **Potential for the recent spike in long-term bond yields, if sustained, to fuel a further acceleration of downward revisions to estimates of long-term global economic growth potential** as overall net indebtedness levels remain elevated. These pernicious dynamics flourish at this stage largely on the back of the multi-year long period of quantitative easing in the USA and the UK together with measures of a declining output gap in much of the developed world at a time when the productivity growth is weak and labor force participation anemic.

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> "…the Glovista investment team has implemented a number of portfolio rebalancing actions over the past several weeks, entailing the following: reduction in overall equity market exposure with the exception of Emerging Asia equities; sustained underweight allocation to commodities, including a cut in allocations to soft commodities, and; increased exposure to long-dated US Dollar high grade corporate debt."

- **Potential for overshooting in long-term bond yields following the recent bond market sell-off period as 'convexity selling' by institutional investors and front-loading of debt issuance by corporations unfolds.** These two technical factors appear to have been present in the marketplace these past several weeks as a large number of high grade debt issues have come to market, likely as a result of corporate treasurers and CFOs' intent to complete their funding programs ahead of the rate hike by the US Federal Reserve and the consequent rise in volatility that most investors expect following the first interest rate hike in 9 years.

In reviewing some of the likely macro and market implications listed above, it is clear that some of these carry the potential of serving as correcting, at least partially, the recent blow-up in long-term bond yields. For example, a strengthening US Dollar amounts to a tightening of US financial conditions. That the US economy is the world's largest and one of the key contributors of the current world economic expansion implies that a tightening of US financial conditions reinforces the disinflationary effects of weaker commodity prices. Against such backdrop, we expect a significant retracement in the recent rise of long-term bond yields given (a) that the European economy's output gap is notably larger than the US or the UK; (b) the ECB's commitment not only to continue but to intensify its quantitative easing program, and; (c) the payback effects in bond yield movements that are likely to result from the normalization of the temporary technical bond market dynamics noted in the above paragraph.

Glovista Lowers Overall Equity Exposure, Sustains Minimal Commodity Market Allocations and Raises Exposure to Long-dated US Dollar High Grade Corporate Debt

As a result of the above mentioned considerations, suggesting a heightened potential for the entry into a risk-off period across all asset classes including equities, the Glovista investment team has implemented a number of portfolio rebalancing actions over the past several weeks, entailing the following: reduction in overall equity market exposure with the exception of Emerging Asia equities; sustained underweight allocation to commodities, including a cut in allocations to soft commodities, and; increased exposure to long-dated US Dollar high grade corporate debt.

As for the above mentioned rebalancing in favor of increased exposure to long-duration US Dollar high grade corporate debt, such action reflects a number of considerations including: our more constructive stance towards the US Dollar; our assessment that the recent pullback in long-term yields has unlocked value in that space given our continued expectation for long-term US nominal GDP growth in the vicinity of 2.5 percent (the result of productivity, labor force and core PCE growth rates). Moreover, we believe the recent pullback in long-term yields has been exacerbated by US corporates' decision to front-load their funding programs ahead of the Federal Reserve's first rate hike later this year (expected to be in September), as well as the well-known convexity selling of bond duration fueled by the large sized sell-off in bond prices witnessed since the beginning of April. Prior bond market cycles remind us that such technical dynamics are likely to fuel self-correcting adjustments as the Federal Reserve's first rate hike approaches.

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