Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

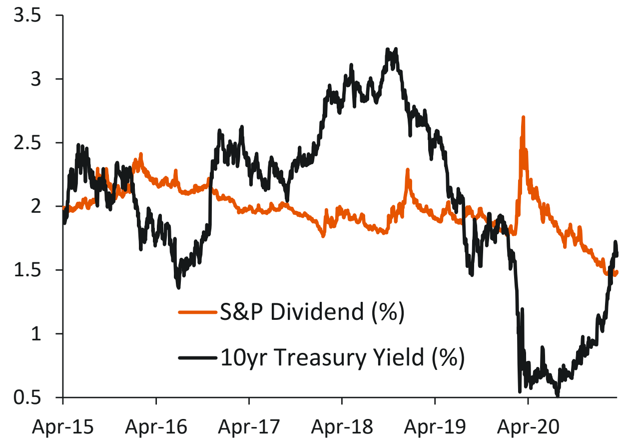
April 1, 2021

Making the Bullish Case for Bonds

Please see this week's ***Rate Sheet*** *and* ***Yield Curve Opportunities****.*

The explosion in liquidity on financial institution balance sheets has made many institutions mildly to aggressively asset-sensitive, even without management teams taking proactive actions in that direction. Yet management teams worry about deploying that cash, or extending duration, even when their interest rate risk positions says they should, because of potential rising rates. Expectations of stronger economic growth and rising inflation have pushed long term rates significantly higher, but there are emerging reasons why the bond selloff may not continue. The relative advantage the S&P 500 dividend yield has held over the benchmark U.S. Treasury note since 2019 seems to have vanished. The US has the highest yield levels relative to most developed countries providing an attractive alternative for many foreign institutional investors. On a currency-hedged basis US bonds offer yields of more than 1% to euro and yen based investors compared to their domestic bonds. While the ballooning US debt is a concern, what matters is the cost of debt, not its size. With Fed funds near zero the cost of debt remains low and allows the issuance of more debt without pressuring rates higher.

Figure 1: The relative advantage of the S&P dividend yield over U.S. Treasuries has vanished



Source: Bloomberg, Piper Sandler

Since the beginning of the year interest rates have moved sharply higher with the 10-yr Treasury rate increasing by more than 70bp to 1.68%. Reflation fears along with a strong rebound in economic growth as a result of the trillions of dollars spent by the federal government have been key drivers of the bond-selloff. In addition, the ballooning US debt has many investors worried that the US government will get punished by the "bond-vigilantes" for all the profligate spending. While these are sound reasons for the bond market to sell-off (as it has), there are also emerging reasons why the rate selloff may be restrained.

Figure 2: The US is one of the few developed countries that has positive interest rates across the entire yield curve

Global interest rates (%)

	2yr	3yr	5yr	7yr	10yr	30yr
Switzerland	-0.80	-0.77	-0.77	-0.77	-0.33	-0.08
Germany	-0.72	-0.76	-0.68	-0.58	-0.35	0.21
Finland	-0.69	-0.69	-0.58	-0.41	-0.18	0.46
Belgium	-0.71	-0.68	-0.54	-0.37	-0.04	0.74
Austria	-0.67	-0.64	-0.53	-0.42	-0.12	0.49
Netherlands	-0.69	-0.73	-0.66	-0.53	-0.21	0.29
France	-0.64	-0.69	-0.61	-0.42	-0.10	0.76
Spain	-0.53	-0.45	-0.32	-0.08	0.29	1.22
Italy	-0.42	-0.31	-0.04	0.19	0.62	1.61
Greece	-0.11	-	-	-	0.86	-
Japan	-0.14	-0.13	-0.13	-0.05	0.08	0.66
UK	0.05	0.14	0.33	0.55	0.76	1.28
US	0.14	0.31	0.87	1.34	1.68	2.38

Source: Bloomberg, Piper Sandler

Bond yields overtake stock dividends

First, the equity market usually has a difficult time coping with higher rates, especially when real rates increase swiftly instead of gradually. In a recent publication we argued that higher real rates suggest economic growth is gaining traction, but the increase may adversely impact risk assets. Rising real rates may trigger a measured or panic-driven rotation out of stocks and into bonds, thus limiting any significant rise in nominal yields. Furthermore, the recent rise in interest rates puts the 10yr Treasury rate above the S&P 500's dividend yield of 1.45% (Figure 1). The relative advantage that the S&P 500 dividend yield has held over the benchmark U.S. Treasury note since the early summer of 2019 seems to have vanished. This move could increase the risk of a rotation out of stocks and into bonds as higher rates renders high-flying stocks less attractive.

A big incentive for foreigners to buy American

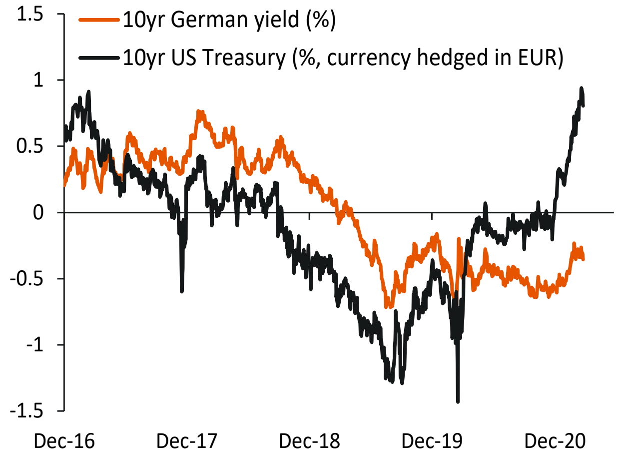
Second, interest rates have turned negative, for several developed countries, across the entire yield curve. With the US sporting the highest yield levels relative to most developed countries, US debt will remain an attractive alternative for many foreign institutional investors. The 10yr government rate in Germany is -0.35% while in Japan it is 0.08%. On the other hand, 10yr Treasury yields are about 1.68%. In fact the US is one of the few developed countries that still has positive interest rates across the entire yield curve (Figure 2).

The appeal of US debt for foreign investors is further reinforced when we also account for currency hedging costs. Large international investors usually hedge their holdings of foreign bonds by borrowing US dollars in exchange for their own currency and locking in a future FX currency rate. Currently, buying a 10-year Treasury and buying a hedge in euros for 3 months will earn an investor pickup of around 1.24% over what they would get buying a German bund (Figure 3). Prior to 2020 hedging costs were large enough h that this trade would not have been profitable. Similarly buying a 10-year Treasury and hedging in yen will earn an investor pickup of around 1.25% over what they would receive buying a JGB (Figure 4). Therefore, foreign sponsorship could become an important source of demand for U.S. Treasuries thus curbing any meaningful rise in nominal yields from current levels.

Debt cost matters more than debt size

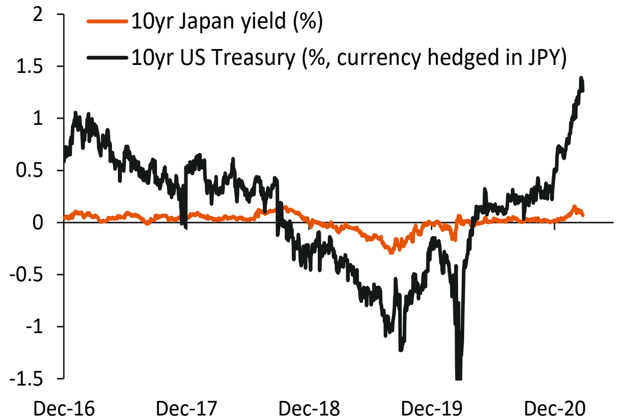
Increasing debt issuance should push yields higher, but empirical evidence (at least for developed countries) illustrates the contrary. A case in point is Japan, where the gross government debt to GDP ratio between 1991 and 2020 increased from 66% to 266% and yet Japanese 10yr government rates dropped from 6.50% to near 0%. Similarly, in the US between 2000 and 2020 the marketable government debt/GDP ratio has increased from about 30% to over 100% and yet 10yr Treasury rates have dropped from 5.00% to 1.68% currently (Figure 5).

Figure 3: Currency hedged Treasury yields have soared



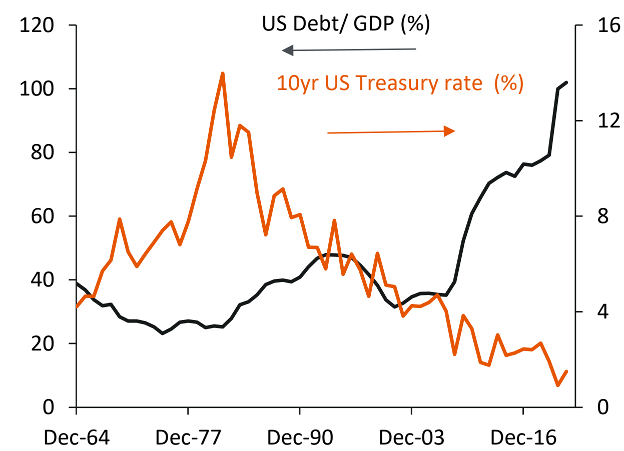
Source: Bloomberg, Piper Sandler

Figure 4: For JPY based investors Treasuries have not been this attractive since 2016



Source: Bloomberg, Piper Sandler

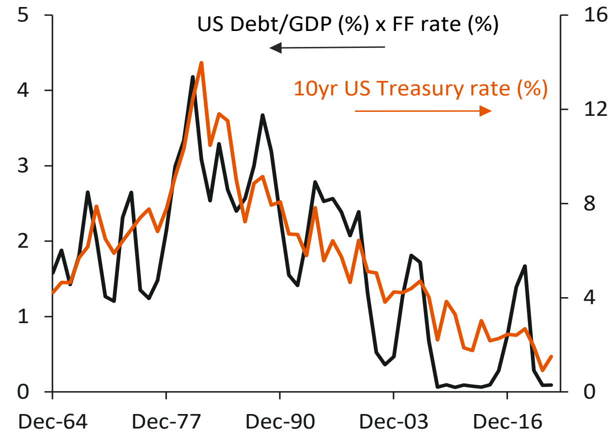
Figure 5: Growing debt levels have not lead to higher rates



Source: Federal Reserve, Piper Sandler

One reason for this counterintuitive result may be that increased government borrowing competes for funds in capital markets, which gradually crowds out private investment and stifles growth as resources are relocated from the vastly productive/innovative private sector to the public sector. As a result, reduced economic growth lowers inflation, which in turn causes interest rates to drop.

Figure 6: The low cost of debt may continue to keep rates low



Source: Federal Reserve, Piper Sandler

Another explanation may be that the market views the cost/interest of government debt as negligible given the low rate environment. This view is most likely driven by the Fed's forward guidance policy that it will keep rates near zero for a very long time. As a proxy for the apparent cost of debt we multiplied the debt/GDP ratio with the Fed funds rate. Figure 6 illustrates the relatively strong relation that emerges between 10yr Treasury rates and the cost of debt. The Fed funds rate has a strong correlation with the 10yr Treasury rate and our calculation may be unintentionally generating some of the conclusion we are seeking. Nevertheless, we believe that the calculated cost of debt captures to a large extent the rationalization by markets that debt accumulation is not a threat to the economy when interest rates are very low. However, if the federal debt trajectory continues to incessantly spiral upwards, investors will start questioning the ability of the US government to repay its debt and at that point will demand higher rates. But we are not there yet. More importantly, the Fed is bent on letting this recovery proceed unhindered and will not tolerate a frenzied move higher in rates from any bond vigilantes.

Every asset-sensitive bank should understand the part of the curve that matters most to their current balance sheet and develop a plan, such as adding duration from purchases, putting on receive-fixed swaps, paying fixed swaps on liabilities, or some other combination. Just waiting for rates to increase is not a sound plan, however daunting the decision process may be. We're here to help. If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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