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Investments



# Global macroeconomic update

## Key themes

- The fixed income market has frayed from the medium-term fundamental outlook
- Four drivers – positioning, risk management, concerns over a Fed policy error and emerging concerns over the Delta variant – have to various degrees weighed on rates
- Taking a slightly longer-term view we continue to see rates resetting higher later this year as the market gets back to fundamentals; however, tactically in the shorter-term these drivers are likely to not completely disappear and could keep rates rangebound for a while

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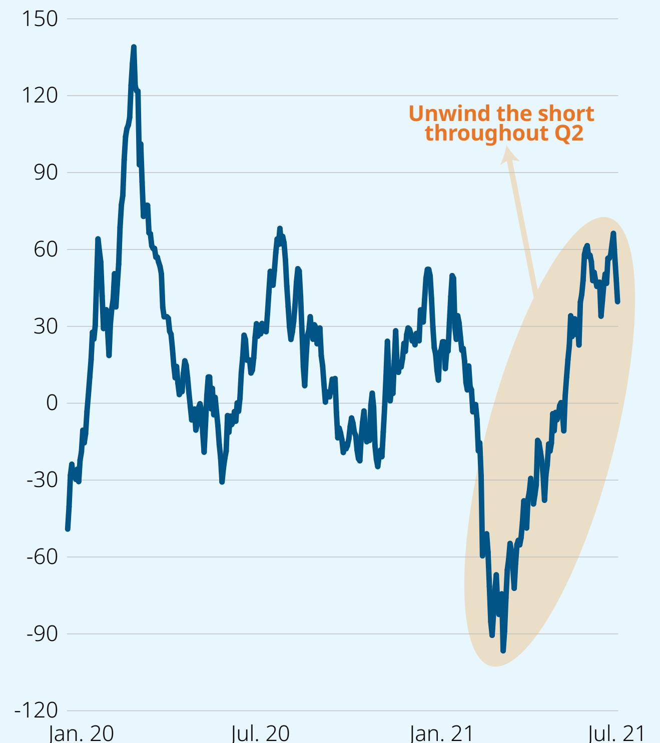
## Detached

The fixed income market has been misbehaving – or at least not behaving as many think it should. With global central banks slowly turning ever more hawkish, the Fed finally (talking about) talking about removing tapering accommodation and the fundamental picture generally looking more constructive, the foundation had been laid for yields to move higher. But not to be. Detached indeed.

As longer-term readers of this space will know we generally try to not spend too much time looking in the rearview mirror, preferring to look forward dynamically at what key drivers will likely affect markets going forward. However, the price action over the past few weeks in the fixed income space has gone notably against the fundamental backdrop and so we believe it is reasonable to reflect, analyze and better understand what has been driving markets and why. Not wanting to throw every reason for the rate move at the wall just to see what sticks, we see four main drivers as to why rates have been trending lower over the past few weeks despite the improving fundamental picture. No one specific driver is likely singularly responsible and all four, we believe, are at least partially responsible for driving fixed income markets.

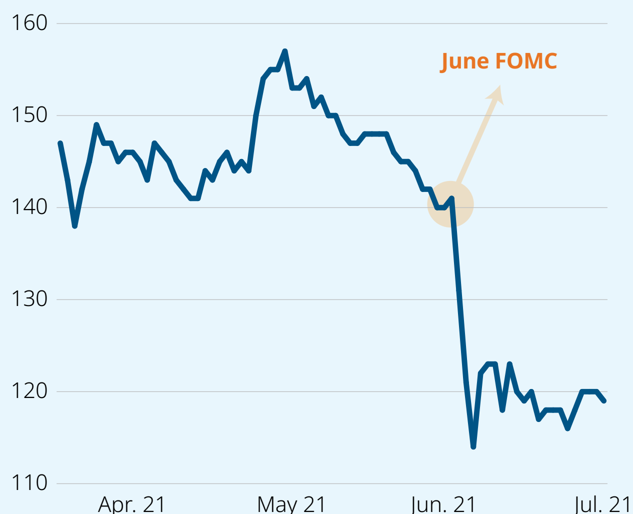
The first is market positioning; simply put, almost everyone was positioned to be short fixed income (yields higher) suggesting it became a very crowded trade by the end of Q1/21 (please see Chart 1). For a period of time it was difficult to find almost anyone who was significantly long duration, especially among the larger players. Generally speaking, crowded trades cannot last forever and there needs to be new entrants coming into the trade and going in the same direction in order to keep the momentum going or the trade runs out of energy and there is a strong risk of eventual capitulation.

**Chart 1 | Total UST Futures Positions**
(Daily, USD bn, January 2020 - Present)




Sources: Citibank Research; Mackenzie Investments

Second, and somewhat related to the first driver, is the notion of risk management and in turn, flows. A lot of balanced funds in the real money space (non-leveraged) and multi-strategy funds in the leveraged space have likely seen outsized equity gains thanks in part to abundant cash in the financial system, low rates, decent corporate earnings and a reopening that has occurred on average probably faster than many expected three or four months ago. Those factors propelled risk assets - not only equities, but also other assets like some commodities and real estate - to fresh highs. Prudent risk management suggests that when the riskier portion of your portfolio becomes outsized relative to the less risky part, one way to manage that risk is to rotate towards lower risk assets to hedge out risk. Fixed income, particularly high quality government paper, is often a good candidate for where to park those funds, at least in the short-term. Those rotational flows have likely been impacting the longer-end of the curve.




Third, the market's read on the Fed's June meeting ex-post was almost unabashedly hawkish given the increase in the 2023 median DOTS (Dots express Fed's members projections for future interest rates) from no hike to 50bp coupled with three additional members joining the 2022 liftoff scenario. So much so, we quickly began picking up that many in the market thought the Fed could be on the precipice of a policy error by tightening rates too quickly (although we disagreed with that view and still do). This further fed into the flow and position unwinding narrative that was already underway in fixed income given drivers one and two above with curve flattening despite the still-strong fundamental picture and the unfolding scenario of higher-than-expected inflation and wages (please see Chart 2).

Finally, we would be remiss if we did not highlight the Delta variant surge as a driver. There are some in the market who are entirely dismissive of the global surge as a driver. There are some who are pointing to the growing numbers of Delta variant cases as the key driver for why long-end rates have been trending lower noting the shape of the curve is behaving more like a long-term hedge. We believe it is impossible to say that the uptick in cases is not having an impact on the rate market, although we do not see it as the main driver of fixed income price action over the past few weeks. That said, we do believe as a theme, concerns over the Delta variant are likely to increase in importance for markets for the next few weeks or months as opposed to dissipate. There are too many EM countries that can be negatively affected by the Delta (or Lambda) variant that could add to already strained supply-chain tightness as well as a large enough unvaccinated population in the US that although is still a risk case scenario, could result in school closings, labour market slowdowns and a Fed that pays attention and alters its policy timeline.

Markets cannot trade off of positioning, flows and momentum forever and at some point, it will get back to fundamentals. We continue to believe rates should normalize looking out three- to six-months, with the market just having unwound its massive short position, financial conditions remaining relatively loose, risk assets continuing to perform well, a market that is not entirely buying into the idea that the Fed won't tighten quickly despite booming inflation data that is looking less transitory and news around the virus that is likely to worsen and not improve.  We also acknowledge from a tactical perspective that longer-end nominal rates could trade sideways or at least choppy in a range for a while longer before the uptrend resumes.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