



What is the “Short of a Lifetime” today?

In 2015 Bill Gross, the famous American fund manager co-founder of PIMCO and currently at Janus Henderson, called the German Bund the “short of a lifetime”. At the time the 10yr yield was hovering around 10bp and soon it quickly reached almost 100bp, only to go back to a negative yield in 2016!

Since March this year I have woken up in the morning thinking that a 0.3% yield on a 10-year government bond, even if issued by the rock-solid Germany, is not worth considering. Today, after six months, that yield is still only at 0.40%; so it was not worth considering neither as a long, nor as a short position once you factor in the costs and the time (i.e. the rolling yield).

For those less familiar with bonds, when the yield decreases, the price of the bond goes up and viceversa; while a rolling yield is the return that could be achieved (if there are no movements in rates) by buying a bond and holding it for some time, enjoying the carry (interest) and the fact that the yield curve is usually upward sloping (so the passage of time means that the bond’s yield goes down, all else equal).

I understand that I am in good company, since apparently many famous fund managers have been frustrated by their **short or negative duration bets**, whether they were on US, Eurozone, UK or Japanese rates. So, what do we make of this strategy going forward? Shall we dismiss it as foolish, given all the geopolitical and macro risks, as well as what seems a deep-rooted dovishness by Central Banks? This is an important question because I think that **interest rate duration is one of the main risks in global portfolios** and is currently **underestimated** because of the relative calm in rates that we have experienced for many years, courtesy of ultra-loose monetary policies globally.

What happens if Central Banks discover that they have to tighten faster than expected? Opinions may differ, but my dollar is on a set of disruptions in many asset classes, i.e. stocks, High Yield bonds, Emerging Markets and, last but not least, Developed Markets’ interest rates. For example consider Japan: it is a huge creditor to the world thanks to its savings and QE – i.e. Japanese buy more foreign assets/investments and lend more to foreigners than the viceversa. A repatriation of money into Japan thanks to better internal yields would have major consequences on assets globally.

Central Banks around the world are now standing on the wrong side of heaven and the rightful side of hell.

The wrong side of heaven because loose monetary policies fuel growth, but too loose policies late in the cycle risk overheating the economies. The rightful side of hell because tightening the policies would face infuriated politicians and businesses (for example see the Trump or Erdogan irate comments on their respective Central Banks) and would deflate asset price bubbles, hence upsetting investors. Eventually though this would be the best option to avoid another boom-and-bust cycle.

The chart below shows the path of 10yr government bonds’ yield since 2015. Despite the difference in levels, the story is almost the same across the countries: the yields are off their all-time lows of 2016 but have largely stayed in stable ranges since. The two notable exceptions are 1) the only market with rates now higher than in 2015 is the US and 2) Japanese rates are not only the lowest, but they also show the lowest volatility due to the BoJ curve control policies.

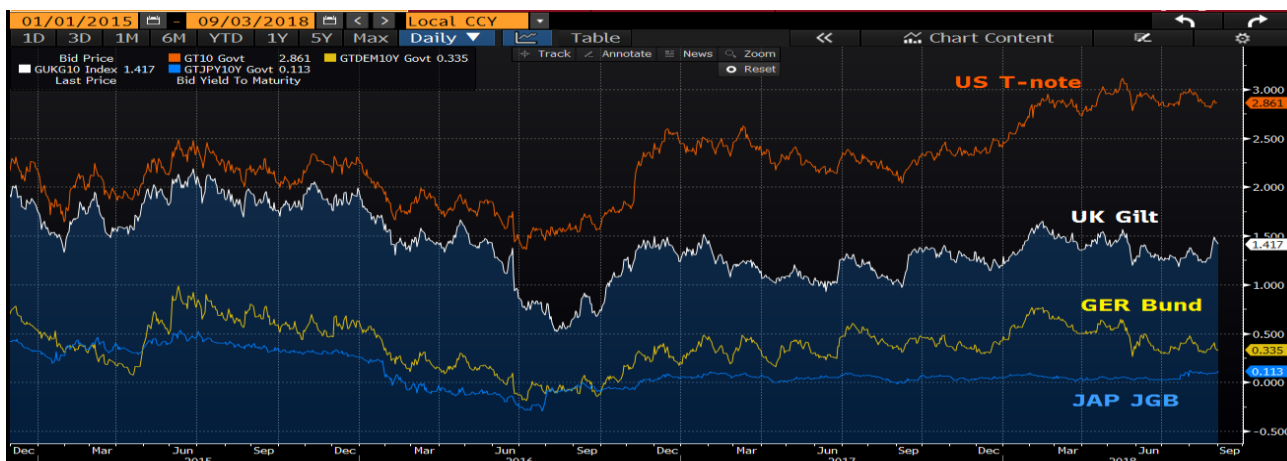


Figure 1 - 10yr yield change for US, UK, Germany and Japan from 2015 to today. Source Bloomberg.

Rate increases anyone?

It is customary to see interest rates as having a risk/term premium which is mostly driven by a) our intertemporal preferences (but nobody really knows what these preferences are in aggregate and how they change) and b) inflation (much easier to assess). I show a host of indicators and monetary policies tendencies in the table below. Summing up, the world is growing at a healthy pace of around 3/3.5% and several regions are above their potential, meaning that a **continuation of growth should create more inflation through pressure on wages and other scarce resources**. At the same time, interest rates remain at very low historic levels and monetary policies around the globe are, in general, very accommodative.

2015 – to date	Short term rate	10 yr Swap	Inflation (CPI)	GDP average	Unemployment average
US (hiking rates)	+175bp (from 0.75% to 2.5%)	+65bp (from 2.28% to 2.93%)	+303bp (from -0.08% to 2.95%)	+100bp (from 2% to 3%)	-135bp (from 5.35% to 4%)
EUROZONE (ending QE, but no guidance on hiking rates)	-5bp (from 0.3% to 0.25%)	+5bp (from 0.81% to 0.86%)	+110bp (from 0.44% to 1.54%)	0bp (from 2.1% to 2.1%)	-245bp (from 11.2% to 8.75%)
UK (beginning of hiking cycle)	+25bp (from 0.5% to 0.75%)	+5bp (from 1.84% to 1.52%)	+270bp (from 0% to 2.7%)	-120bp (from 2.7% to 1.5%)	-120bp (from 5.4% to 4.2%)
JAPAN (maintain QE, but...)	-20bp (from 0.1% to -0.1%)	-19p (from 0.52% to 0.33%)	-70bp (from 1% to 0.3%)	+52bp (from 0.88% to 1.4%)	-88bp (from 3.48% to 2.6%)

Figure 2 - main macro indicators and monetary policies. Own calculations.

In the US the picture seems to be clear: should the momentum persist, rates are going higher still. In all honesty, I actually think that the **US is approaching a macro situation of inflation, growth and unemployment** which in the past saw **much higher short-term rates – in the 4% to 5% region**, as the following chart depicts.



Figure 3 - US macro data comparison: discount rate, CPI, GDP, Core PCE and Unemployment. Source Bloomberg.

This view has been further reinforced by the latest September figures on Non-Farm Payrolls and wage growth.

Something else that really strikes me from the table in Figure 2 is that other areas where there might be potential for steep increase in rates are the UK and Japan.

The UK is hostage of itself and continuously on the verge of a nervous breakdown because of Brexit; but leaving the Brexit debate aside, the BoE does seem a bit behind the curve when considering inflation and unemployment trends. Inflation in UK might be (also) a by-product of the GBP depreciation, but still growth looks solid, albeit volatile and the labour market is tight. **All in all, the 10yr rate in UK has a lot of room to increase.**

Could the 10yr JGB go to 2%?

Japan is another favourite short on rates, not least because nobody believes in it and consequently it doesn't seem like a crowded trade yet. In Figure 4 there is a chart of what has happened to Japanese interest rates in 2018: a rare increase in July after a mostly flat year. Why?

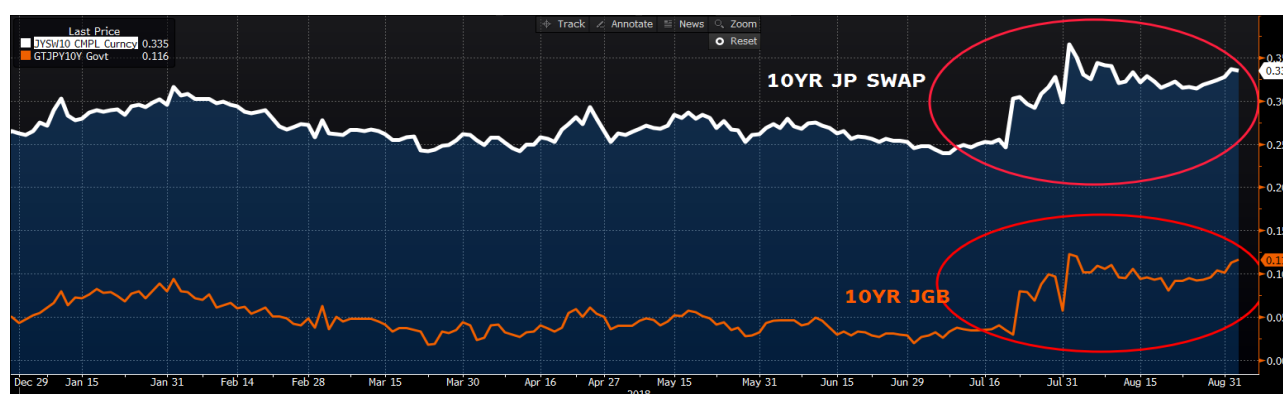


Figure 4 - Japanese rates. Source Bloomberg.

The BoJ has had a massive QE and yield curve control programme since late 2016, which includes stocks as well as government bonds of course. In fact, at the moment the BoJ holds more than 40% of all the government bonds and on the short-term part of the curve almost 100% of all the issues. At the end of July



the BoJ allegedly held preliminary discussions on making changes to interest-rate targets and stock-buying techniques; in other words it seems the central bank is **thinking about decreasing its stock market purchases and allowing higher rates**. But why now? Probably only the insiders know the true reasons, but my bet is that there are now some trends in inflation or its inputs which have not been seen since the '90s.

I was especially fascinated by the **Average Monthly Cash Earnings Index**, which, as the name hints, is a measure of wage pressure. It is worth remembering that wage inflation is typically one of the major inflation drivers.

As the chart in Figure 5 shows, **the current levels of this index have not been seen since the mid '90s**. This bodes well for the reflation target of the central bank. Nonetheless economists are sceptical that inflation will reach the 2% target, because they ascribe the July number to one-off events, like high bonuses due to good companies' profits. My take is that this indicator **has been improving since 2013** and there are no good reasons why it couldn't grow more given the still very benign background of global growth, despite all the good-faith attempts by the American administration to disrupt international trade.



Figure 5 - Japan Average Monthly Cash Earnings. Source Bloomberg.

The scepticism is understandable given the past false signals and the country's long history of deflation. In fact, a quick look at the Core CPI index, in Figure 6, shows that we are well below the 2% target and current expectations are for inflation to grow to 1.5% yoy, i.e. yet still unable to reach the BOJ target.

Also, the 5-year, 5-year JPY inflation swap rate is not moving and does not discount an inflation pick-up yet. Nevertheless, last time the Average Monthly Cash Earnings Index was here 10yr JGB was at 2%. Funnily enough a recent study by Goldman Sachs¹ shows that the long-term "shadow rate" implied by the equity prices and the future expected dividends is around 2.1%. Probably just a coincidence, or not?

¹ "Market-implied interest rates: How high might long-term rates rise if the BOJ abandoned its easing policy?" 6/Sep/2018, T. Ota, C. Vilburn, N. Baba, Y. Tanaka.

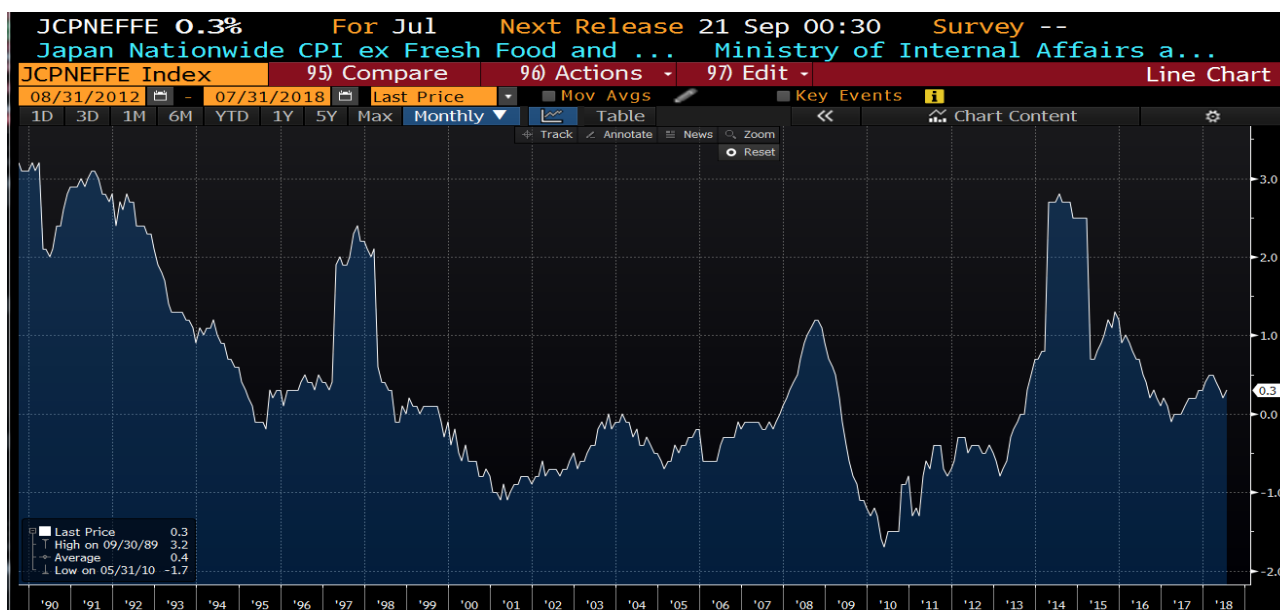


Figure 6 - Japan Core CPI QoQ. Source Bloomberg.

Conclusion: Panta Rhei and Carpe Diem.

The short seller's life is not going to be easy or relaxed: the probability of a quick profit similar to what happened at the time of the Bill Gross's declaration is remote.

But Panta Rhei: nothing is immutable in our universe, not even the Japanese inflation; so those who dare should Carpe Diem and seize the day on shorting rates in US, UK and even Japan and Europe.

On the risk side, it should be remembered that shorting rates is obviously a "bull-market-for-risk" trade. The stock market volatility and the global concerns about the trade wars and the other effects of nationalism as well as the Emerging Markets crisis have so far kept a lid on the Developed Markets' yields; any other weakness on risky assets would probably have the same effect.

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