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Your eyes and ears on the markets

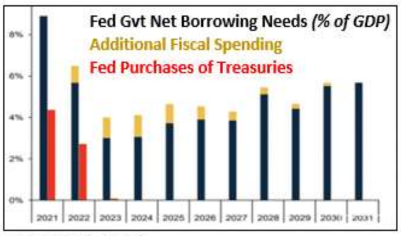
November 15th 2021

THE BULLDOZER

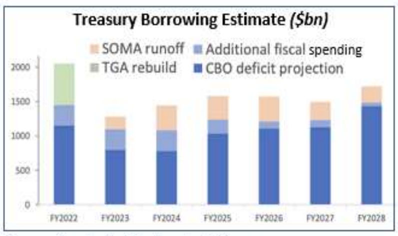
While the debate about inflation is ongoing among strategists & investors, it seems nobody cares about what it means for Treasuries' yields. Like if the Fed was able to control/manipulate the long end of the curve forever, such that negative real yields would be the new norm, the focus being only on when and by how much the Fed will hike (short-term) rates. We continue to believe however that bond vigilantes will do their job before the end of the tapering period.

Meanwhile, the bull camp's bulldozer looks ready to buy everything with 1) Japan under the radar, based on the expectation of some stimulus package to be announced by the end of the week + 2) China & EM, just because positioning is (very) underweight these regions and whatever the fundamentals may be, on the pretext that bad news would be priced in (?) + 3) of course the US, as the buyback blackout period is ending, while daily inflows would still be expected to go on (based on the Great Rotation at the expense of fixed income & money markets). Such a degree of bullishness is shocking but so far, technicals do not point (yet?) to the formation of a larger top in the US & EZ.

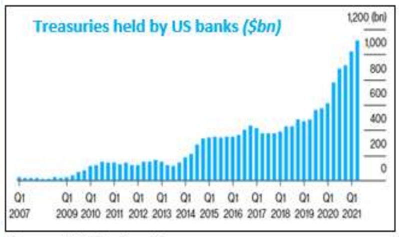
US TREASURY BORROWING vs FED QE + US BANKS TREASURIES HOLDINGS + EZ GVT BOND SUPPLY vs ECB QE + SHANGHAI COMP INDEX vs S&P 500 + ALLOCATION TO CHINESE EQUITIES



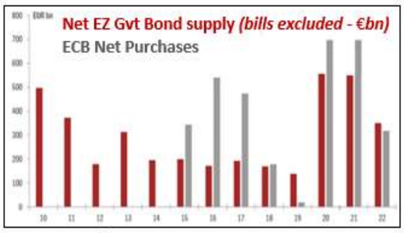
Source CBO - **chart 1**



Source Deutsche Bank - **chart 2**

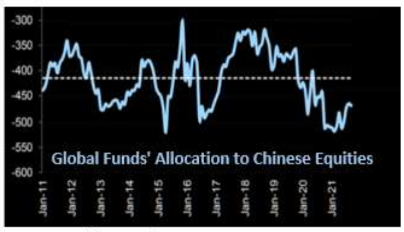


Source FFIEC - **chart 3**



Source ECB - **chart 4**

Source StockCharts.com - **chart 5**



Source Goldman - **chart 6**

With the Fed tapering under way, the key issue on the Treasury market is the moment when there will be no more bull in the china shop. Even if the 2022 long-term debt auctions will be subject to the first reduction in more than five years, it has to be seen in a context where borrowing needs were historically high in 2020 and 2021, because of the Covid stimulus.

Based on the CBO estimates, the US Treasury net borrowings minus Fed QE should amount to 4% of GDP in 2022 (versus 4.60% in 2021). This is still quite high a level whereas all following years should see larger needs (chart 1). Worse, assuming the debt ceiling issue is fixed, rebuilding the Treasury cash balance (ie TGA) at the Fed (which may not only be made up of short-term Tbills) might increase such needs by circa up to $500bn, while the reinvestment policy applied to the Fed balance sheet (ie System Open Market Account Holdings) will weigh from 2023 onwards (chart 2).

Europe will follow the same kind of pattern, albeit less pronounced given the dovishness of the ECB, with gvt debt issuance exceeding the ECB's purchases in 2022 (chart 4). Remains that the past 2 years were subject to ECB purchases largely exceeding the sovereign bonds' supply.

On top of that, comes the issue of the massive holdings of Treasuries by US banks (chart 3), as the latter have been encouraged to snap up "high quality" assets, following new capital requirement rules introduced after 2008. As the total holdings has surged from $25bn in 2007 to $1.1tn in 3Q21, this raises real concerns, would a bond bear market/cycle unfold in the future as we expect.

As to China and EM, the bull camp is full of relative data/samples (charts 5 + 6), calling for a significant rebound. So far they have been proven wrong, while we continue to focus on our negative scenario, noting however that following three large downwaves since the top of February, the China A 50 is as at a key juncture (as to whether a 5th downleg will develop). The good news is that we should get the answer shortly. We will keep you informed of course.

RUSSELL 2000 FUT – DAILY

Our scenario is on track. As long as the top of wave 1 is intact, higher levels remain expected.

S&P 500 FUT – DAILY

The picture is unchanged. We only adjust the levels.

DAX FUT – DAILY

Same comment as above.

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