Global Macro Strategy

Will another hike lead to higher yields and USD?

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Is this the beginning of the end for the "lower for longer" rates regime?

Over the past few weeks, markets have moved to reflect renewed hope of growth acceleration and inflation recovery. The market has priced in a December Fed hike without much damage to risky assets, and higher oil prices have supported a bounce in inflation expectations. At the same time, the dollar has rallied and curves have steepened globally.

There may be some (limited) room for these moves to extend…

In contrast to the run-up to last year's hike when financial conditions had tightened significantly, financial conditions have eased a lot since February, led by narrower credit spreads and higher equity prices. The Fed is also guiding toward a much less hawkish forward path than they were around the first hike, market pricing is closer to the Fed dots than it was a year-ago, inflation is higher, and with fears around Chinese growth reduced, the global backdrop is better.

… but this is not a regime change

It would take a lot to reverse the "lower for longer" regime. Growth in China and the Euro area would need to pick up alongside US growth, oil prices would need to continue their gradual rise, and most important, central banks (the Fed in particular) would have to remain accommodative. We see it as unlikely that all of these happen in combination. Although financial conditions are easier now than they were for the first hike, the growth pick-up remains modest. Inflation is higher, but inflation expectations remain below target, and the upward pressure from rising foreign yields is likely to dissipate.

What to do? Use opportunities to re-engage in long-standing themes

If, as we expect, the low rates regime persists, we would use backups in US 10-year yields as opportunities to receive, and also to position in flatteners, which we continue to favour. Low rates should continue to support positive returns in equities-- high equity valuations are simply the mirror image of low risk-free yields. In FX, lower US yields against higher yields in the Euro area should support EUR/USD, and we remain bullish. We remain bearish GBP and SEK, even after recent weak performance.

A December Fed hike may open up some tactical opportunities as well

Similar to 2015, short-term volatility may rise into the December FOMC meeting. Data has been sufficiently weak that a hike isn't guaranteed, yet policymakers will want to retain the optionality to hike. This uncertainty could push up volatility, particularly short-term volatility relative to longer-term volatility. VIX and AUD/USD are two examples of volatility curves with some steepness. In FX, if US growth remains soft, AUD and NZD could benefit over time as investors reassess the relative attractiveness of higher-yielding G10 currencies.

Are markets better prepared for a hike this time?

Risk markets have spent much of the year in the macro sweet spot, with growth picking up from very weak levels, yet interest rates remaining low. This has supported risky assets and a continuing search for yield. But with Fed rhetoric, market pricing, and our economists' forecasts all pointing to a December hike, is the sweet spot about to end? Or are markets better prepared for a hike than they were in 2015? This is the key question for markets.

Reflation ahead, or another false start?

Over the past year, we have spent significant time writing about the implications of low inflation and low trend growth for global assets. Our research has pointed to global yields remaining at very low levels for longer. Lower rates, in turn, enable higher equity valuations, despite slower earnings growth (see Big Macro 04: Secular stagnation and equities; the new normal). Given the asymmetries in the market's growth expectations for the US versus the rest of the world, these views have, for us, long marked the peak in the dollar versus DM currencies.

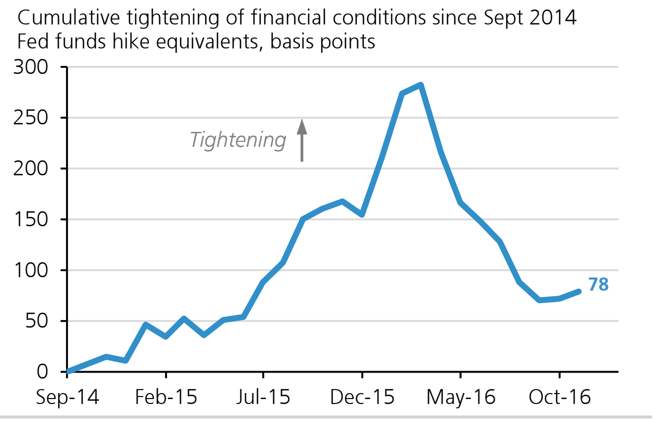
An uneventful Fed hike paired with rising inflation expectations that enable back-end yields and the USD to settle at significantly higher levels is a key risk to our views. Recently, markets have moved to reflect renewed hopes of this outcome, as higher oil prices have supported a bounce in inflation expectations, cyclical and bank stocks have outperformed, the USD has rallied, and curves have steepened.

Why there may be some (limited) room for higher rates…

In contrast to the run-up to last year's hike when financial conditions had tightened by a Fed Funds equivalent of 128bp, conditions have eased significantly this year (Figure 1; see Can one small hike cause a giant tightening?). Since February, rising equities and tighter credit spreads have eased financial conditions by 200bp on our measure, and conditions are easier now than they were when the Fed hiked last (Figure 2).

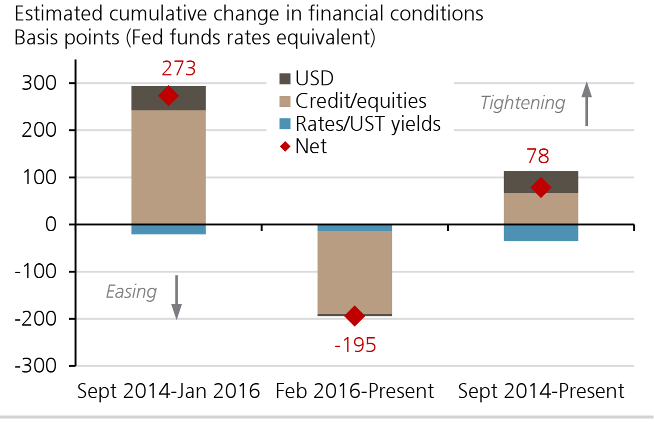
It is also worth noting that the Fed is guiding to an easier forward path than they were at this time last year. This may imply that there is more room for the Fed to hike than there was last December, as does the fact that US inflation is higher than a year ago. With fears around Chinese growth reduced, the global backdrop is better, and base effects from rising oil prices are pushing up y/y headline inflation.

Figure 1: Financial conditions have eased this year…



Source: UBS, Bloomberg. See "Can one small hike cause a giant tightening?"

Figure 2: … mostly because of equities and credit



Source: UBS calculations, Bloomberg.

… but four key reasons why this is not a regime change

Although recent trends can extend, there are limits, and we would view such moves as temporary, rather than as a change in regime.

- **1/ It would take a lot to get a continuation of reflationary price action**

Growth in China and the Euro area would need to pick up alongside US growth, oil prices would need to continue their gradual rise, and most important, central banks (the Fed in particular), would have to remain accommodative. All of these happening simultaneously is unlikely, in our view.

- **2/ Although financial conditions have eased a lot, the growth pick-up has been modest**

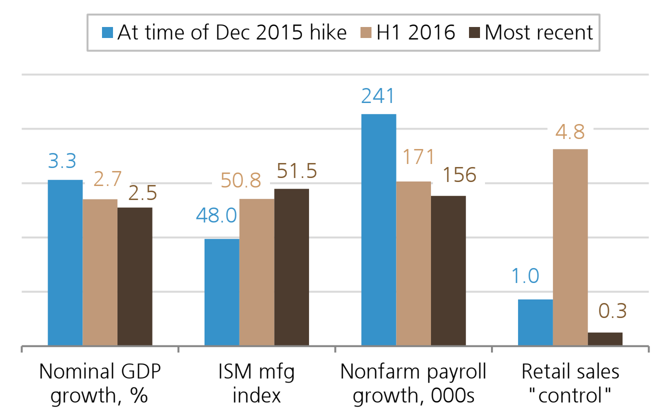
Despite a significant easing in financial conditions, nominal growth was only 2.5% y/y in Q2 versus 4.0% in Q2 2015. Q3 is seeing some acceleration, but it is been small and mostly noticeable because the starting point was so low. Retail sales have been soft, with core sales annualizing at slightly negative rate during the past three months, the manufacturing ISM is at only 51.5, and payroll growth has downshifted (Figure 3).

This puts the easing in financial conditions in a less positive light. Despite a marked easing, the acceleration in growth has been modest. Although disappointing, this is consistent with what we've seen during the past six years-- easier financial conditions are essentially a prerequisite for better growth, and without them, growth slips.

From a forward-looking perspective, it is important to note that on our measure, the easing in financial conditions stalled in August. If the Fed were to hike in December, it would be difficult for financial conditions to ease between now and year end. The only question is how much further they would tighten.

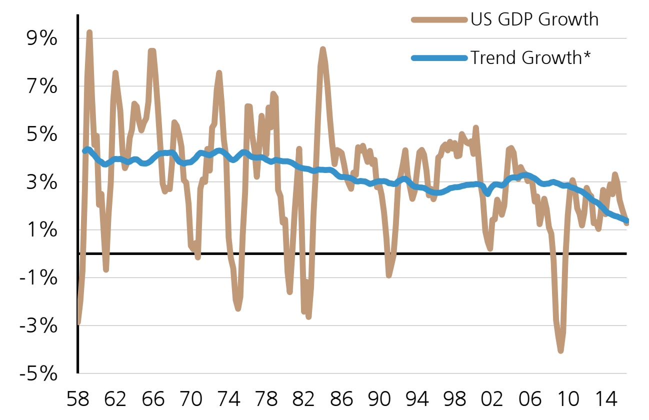
To be fair, trend growth has slowed (Figure 4), so we need to look at GDP growth numbers differently. The continuing decline in initial jobless claims against a backdrop of 2% GDP growth makes this clear. But if trend growth has slowed, that should work against higher yields, as it suggests a lower equilibrium interest rate. It also means that each hike comes with increased risk relative to past cycles.

Figure 3: The growth pick up has been modest



Source: UBS, Haver Analytics. Scaled relative to post-crisis peak.

Figure 4: Trend growth has slowed



Source: Haver, UBS calculations. *Trend growth calculated using Okun's law with a rolling 8-year window of quarterly data.

- **3/ Headline inflation is rising, but base effects are well known**

Although higher oil prices are likely to exert upward pressure on headline inflation, there are offsets. If current prices are maintained, it will likely contribute 15-20bp upside to headline and about 5bp to core. But falling food inflation and lower import prices on the back of a stronger USD/CNY will provide partial offsets.

It is fair to worry about markets being complacent regarding the risk of spillovers from headline to core inflation, but it is also true that markets have generally been good at looking through base-effect driven rises in headline CPI. There have been three notable rises in headline CPI since 2010, and in each case, US 10-year yields remained stable or fell (Figure 5).

Furthermore, markets appear to be well-priced for the impact of higher oil prices on inflation. We looked at US one-year CPI swaps and assumed one-year ex-energy inflation (roughly core inflation) persists in order to back out inflation-linked market implied one-year forward crude prices (Figure 6). Notably, the inflation-linked market pricing of crude is almost the same as crude futures market pricing.

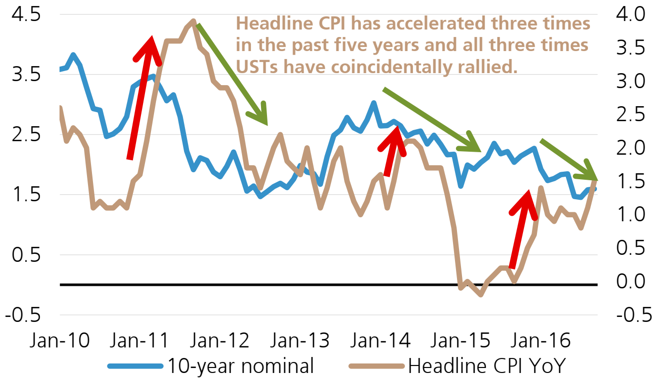
Finally, despite the rise in inflation, inflation expectations remain low. Market-based measures have risen significantly from the July lows, but they remain low in absolute terms. Surveys are delivering a similar message, with the University of Michigan's 5-10 year-ahead inflation expectations measure at an all-time low. A December Fed hike, or talk of it, against a backdrop of still-low inflation expectations may contribute to keeping inflation expectations below target.

- **4/ Foreign yields helped start the move, but are unlikely to continue it**

We have argued that global yields have had an increased impact on US yields this year. In July, we estimated that of the 85bp year-to-date decline in US 10-year yields, foreign yields were responsible for about 48bp, a higher proportion than usual. Since mid-July, US 10-year yields have risen 30bp. Updating our model, we estimate that 7bp has been from higher Bund yields, 5bp has been from JGBs, and 7bp has been from the Gilts (Figure 7, next page).

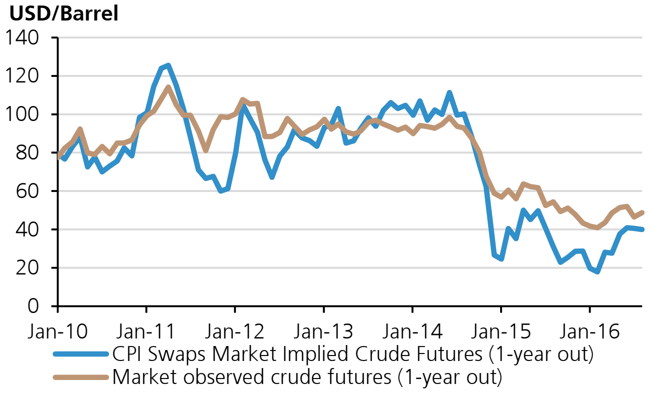
Going forward, the only place we see room for yields to rise further is the Euro area, while we think it will be difficult for JGBs to sustain a further rise, and in the UK we expect Gilt yields to fall. Even if Bund yields rise another 20bp this year, that would only add another 10bp to US yields in our framework.

Figure 5: Higher headline CPI hasn't pushed up yields



Source: UBS, Bloomberg, BLS.

Figure 6: Markets priced for higher inflation from oil



Source: Bloomberg, UBS calculations.

What to do?

- **There are fresh opportunities to engage in core themes**

In rates, we expect a continuation of the low rate environment. US 10-year yields should fall from current levels, though not quite as much as previously-- we recently revised our year-end forecast up to 1.60%. We would view any rise in US 10-year yields to the 1.80-1.90% range as an opportunity to receive rates, as well as to position in flatteners with a compelling risk-reward.

Equally, we see the steepening in Gilt yields as overdone (despite our bearish GBP views) and also see favourable risk-reward in receiving the GBP 2y2yF swaps.

The low yield environment is much better priced in the Euro area. We see room for tweaks in the ECB bond buying programme modalities leading to higher Euro area yields, and we forecast Bund yields at 15bp by year end.

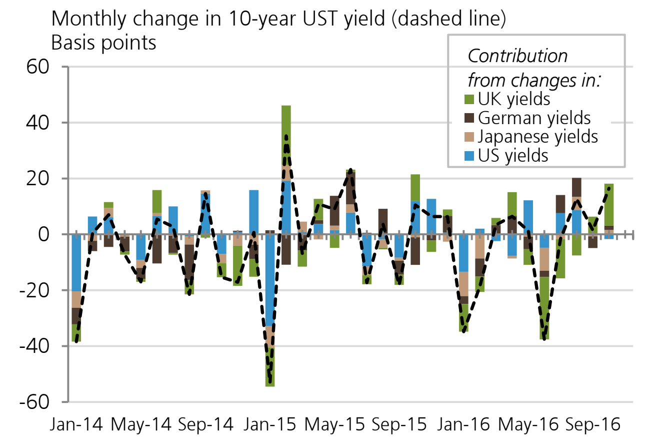
In equities, we see room for continuing positive returns. In a low yield environment, equity investors are not complacent. High equity valuations are simply the mirror image of low risk-free yields. Indeed, our indicator of global risk aversion continues to point to above average levels of cautiousness, albeit much less so than six months ago (Figure 8). Any sell-offs should be viewed as buying opportunities, particularly in dividend stocks, where we remain bullish.

In Europe, the valuation story is a bit different. A 12-month forward P/E of 14.8x doesn't look that cheap, but it is based on trough earnings, and the discount to the US is still at crisis highs. Such a valuation is only justified if there is no earnings growth from here, which is not the expectation of our European equity strategists.

In FX, we remain bullish EUR/USD. The combination of lower US yields and higher German yields should support EUR/USD. The euro remains cheap in our view, and continuing economic re-synchronization between the US and Euro area should gradually push it toward fair value.

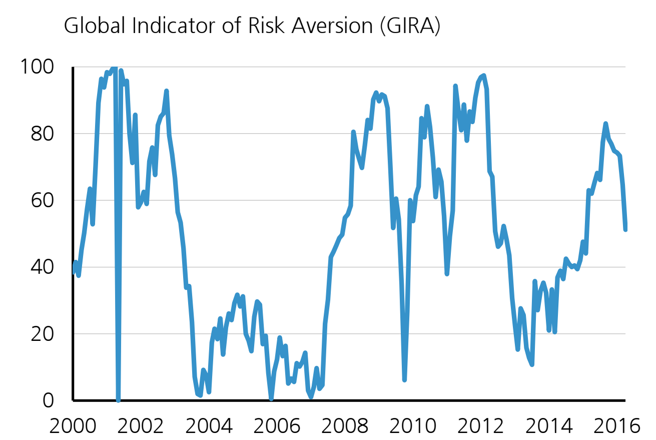
We remain bearish GBP and SEK, the two weakest currencies among G10 FX. Given the UK's large current account deficit and need to attract capital, further adjustment lower in GBP will be necessary. We also remain bearish SEK, where persistently low inflation makes long EUR/SEK a good hedge to risk-on positions.

Figure 7: Foreign spillovers to Treasuries



Source: UBS, Bloomberg. Note: Based on vector autoregressive (VAR) model using monthly changes in 10-year yields. See previous note for details.

Figure 8: Risk aversion fell, but remains above average



Source: UBS calculations, Haver Analytics, Bloomberg.

- **There are tactical opportunities as well**

If growth remains soft, a December Fed hike (or the spectre of one) or rising back-end yields could lead to some weakness in risk assets. Big Macro 5 argues that we should generally avoid trading short-term shifts. Market routs have become more frequent since 2008, sharper and more violent. Yet, have reversed a lot faster than in the past. Sticking with the trend has been the winning trade: back-ups in yields can occur and stir markets – yet a regime shift for stocks and bonds seems unlikely.

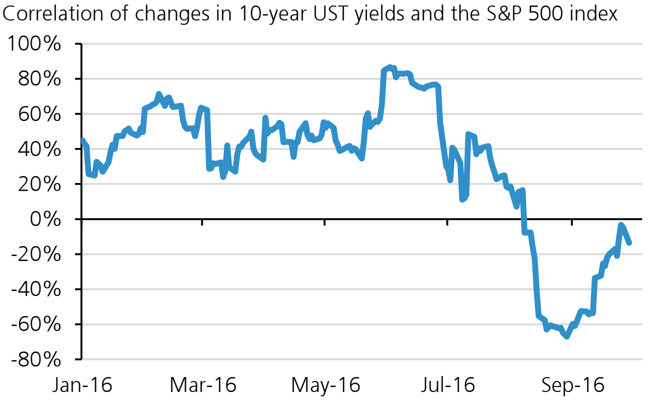
Similar to 2015, short-term volatility may rise into the December FOMC meeting. Data has been sufficiently weak that a hike isn't guaranteed, yet policymakers will want to retain the optionality to hike, and lean against market pricing for a December hike falling too far. This uncertainty should push up volatility, particularly short term relative to longer term.

Although Big Macro 5 argues against generally trading short-term shifts, it also notes that a combination of policy, macro, and market variables post-GFC has created dislocations in the term structure of volatility (arguing for flatter volatility curves), making long short-term volatility versus short long-term volatility potentially appealing. Two possible examples: the June 2017 VIX contract is two points above the January 2017, while in AUD/USD, 12-month implied volatility is more than one vol point above 3-month implied volatility.

If weaker data prevents a December hike, or if negative market reaction ensues, AUD and NZD could over time benefit as investors reassess the relative attractiveness of higher-yielding G10 currencies. Any difficulty with a December hike would further embed the lower-for-longer narrative in rates and the search for yield. With Australia and New Zealand continuing to show robust growth (3.3% and 3.6% y/y, respectively), both currencies could benefit. We have moderated our bearish AUD and NZD forecasts in recent months, and are reviewing them again.

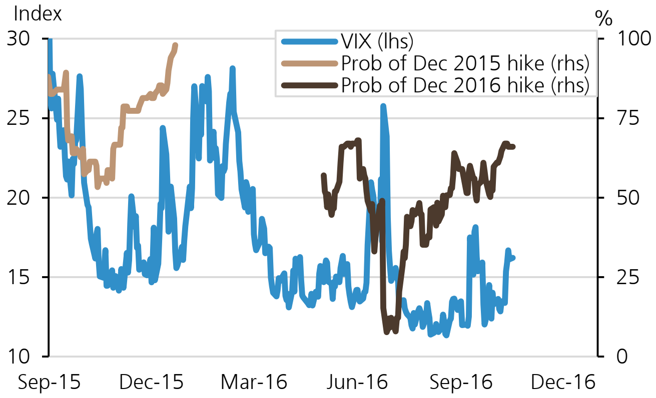
Finally, a looming Fed hike may limit near-term upside in risk assets or downside in the dollar. Such impacts are likely to be limited over time, as weaker equities and/or a stronger dollar tighten financial conditions. If either happens to a significant enough degree, the Fed would in all likelihood lean against such moves given the importance of financial conditions to the real economy. Over time, we expect positive equity returns and a weaker dollar. Calendar spreads in equities and FX may be good expressions of these dynamics.

Figure 9: Higher yields have been less benign for equities



Source: Bloomberg, UBS. Rolling 20-day correlation.

Figure 10: Is volatility priced for the next hike's arrival?



Source: Bloomberg, UBS.

Signposts and risks

It is possible that the run-up to the Fed hike is uneventful. Once market pricing for last December's hike reached 60%, the dollar and yields were relatively flat in the final four weeks leading up to the hike. In this regard, it will be important to watch:

- **Inflation expectations**

Inflation expectations are a key barometer for markets and the impact of another hike. Inflation expectations fell sharply around last year's hike, suggesting that markets may have seen Fed policy as overly hawkish. Inflation expectations have risen in recent weeks, but if they are unable to continue rising toward 2.0% and instead fall back lower, market reaction to another Fed hike will likely be negative. Higher rates, without a concurrent rise in inflation expectations, increases real rates and tightens financial conditions, a negative combination for asset markets.

- **USD/CNY**

As it did last year at this time, USD/CNY is rising into the hike. Although the move isn't especially large in nominal or trade-weighted terms, in a world that had gotten used to a persistently stronger CNY, weakness can be disinflationary, both for the US and smaller open economies in Asia. A number of small open economies in Asia, including Singapore and Taiwan, have seen significant currency appreciations versus the CNY this year, and in addition to weighing on competitiveness, it will also push lower already-low inflation, pressuring SGD and TWD.

- **Feedback loops between the dollar, rates, and equities**

We have been writing about feedback loops between the Fed and markets for a while. These loops provide important limits to policy and price action, as there are limits to the amount of market weakness that a hawkish Fed can cause, as the pass-through to financial conditions ultimately turns the Fed more dovish, creating self-correcting mechanisms. At the same time, risk markets have trouble breaking out, as stronger equity prices impact the Fed's reaction function as well. These dynamics remain in place, and are likely to keep markets difficult to trade.

- **Market pricing of future hikes**

Finally, it is important to watch market pricing. A key difference between the current backdrop and last year's hike is that the market and Fed are currently expecting much shallower paths after this hike than they were last December. At that time, the Fed projected four hikes for 2016 and the market priced about two. Now, the Fed "dots" show expectations of only two hikes in 2017 and the market prices less than one full hike next year. This can be taken positively for risk assets, as it sets an overall more dovish backdrop and implies that markets and the Fed are more aligned this time. But it can also be viewed negatively: if something goes wrong, the Fed and markets have less room to ease expectations for future policy and financial conditions

Valuation Method and Risk Statement

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