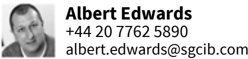
Global Strategy Weekly

"This bubble will burst in due time no matter how hard the Fed tries to support it"



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Towards the end of 2018 a rise in bond yields above 3% caused the equity market to unravel and forced the 'Powell Pivot'. Today with US 10y yields breaking above 1% we have reached exactly that same level of vulnerability for the equity market.

■ Two of the most respected voices in finance, Jeremy Grantham and Fred Hickey, have written recently warning about the increasing vulnerability of the massive equity bubble that the Fed has inflated. Fred Hickey makes the point, *"This is a full-blown stock mania and all of the traditional warning signs are there to see. The general public (missing until relatively recently) has piled in (they typically come in near market tops)."*

■ I think one of the most important points that Jeremy Grantham makes is that, ***"this bubble will burst in due time <u>no matter how hard the Fed tries to support it</u>, with consequent damaging effects on the economy"*** (you can read Jeremy's excellent article here).

■ This is where the overwhelming majority of market participants disagree with we veteran equity bears who have seen bubble after bubble burst at first hand. Even those who might agree that the stock market is a bubble remain bullish for one reason only: namely confidence that **the Fed simply *cannot* allow this stock market bubble to burst due to the impact on the real economy. So they also buy the corollary that the Greenspan Put is alive and well and the Fed *will not allow* the bubble to burst.** The incredible V-shaped recovery of the stock market in March last year has only further strengthened investors' belief in the Fed.

■ But for people like Jeremy Grantham, Fred Hickey and myself the idea that the Fed is omnipotent is bunk. Sure, they can kick the can down the road for a long while but eventually that can will hit a brick wall to rebound and hit them right back in their faces.

■ One imminent risk for stock market bulls is the belief that a robust economic rebound later this year will cause a sharp rise in inflation. This combined with a tsunami of bond supply would drive up US bond yields, triggering an uncontrollable stock market crash and deep depression.

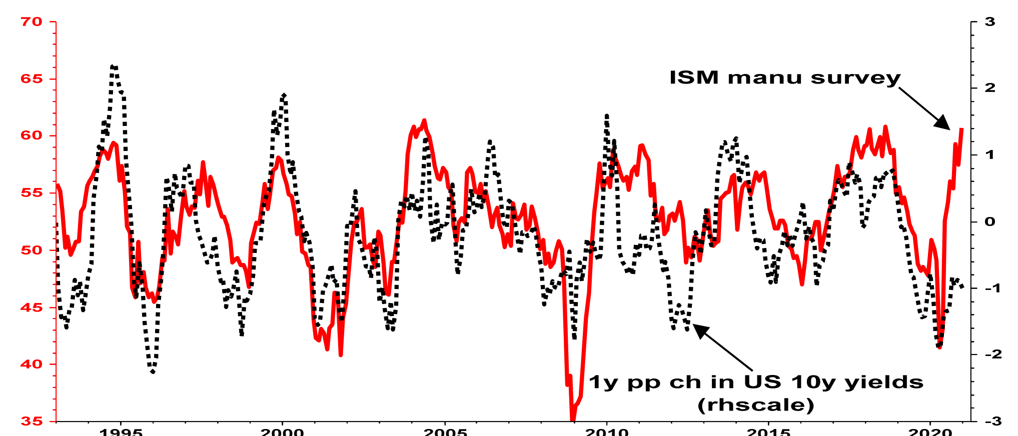
■ Our friends at the *BCA* calculate that even US 10y bond yields now just above 1% could be enough to hit that tipping point where the equity market bubble bursts (see inside). And once it starts, at these extremes of valuation, Jeremy may be right. Even with its foot down hard on the QE pedal the Fed might not stop it – they could just lose control over events.

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	30
Bonds	20-50	35	50
Cash	0-30	5	20

Source: SG Cross Asset Research

This is a typical chart doing the rounds suggesting bond yields are set to surge…



Source: Datastream

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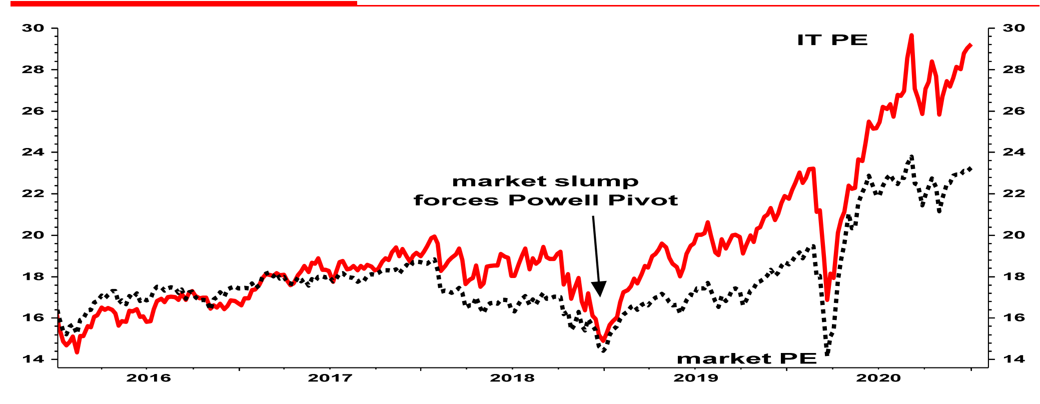
One clear and present danger for the equity market is the current rise in bond yields. Investors will recollect the events towards the end of 2018 that prompted the (in)famous 'Powell Pivot' when the Fed abandoned the reduction of the Fed balance sheet (Quantitative Tightening, QT) despite Fed Chair Powell describing QT a few weeks previously as being "on auto-pilot"!

Essentially what happened was that the rise in US 10y yield above 3% towards the end of 2018 driven by QT began to burst the stock market bubble. The S&P slid 20% in Q4 from an all-time high just shy of 3000, culminating in a slump over the 2018 Christmas holidays led by the tech stocks. The equity market slump forced Fed Chair Powell to ignominiously abandon the QT he had re-confirmed just weeks before. The equity market 'demanded' more QE, not QT, and both Powell and the Fed capitulated. It was a sorry story of the equity tail wagging the policy dog.

We all understood in 2018 (and we still know now) just how dependent this equity bull market is on low bond yields, especially in recent years with the 'Growth' and FAANG stocks leading the market higher. But back then, with the S&P just shy of 3000 and much more moderate multiples than today (see chart below) it took a rise in 10y bond yields above 3% to 'break' the bull run. Now with the US tech sector on a forward PE close to 30x (vs 20x back in Q4 2018, see chart below), it will clearly take a lot less to break the equity market and trigger the bursting of this bubble. But what is that 'danger level' of bond yields?

At much higher valuations what level of bond yields will it take to break the equity market?



Source: Datastream

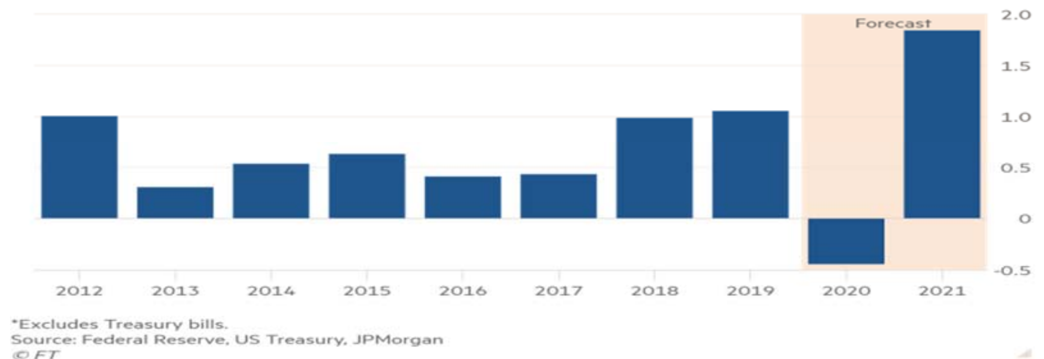
Yields may be still in their long-term downtrend (see chart below), but they have broken out of their recent trading range and the US 10y has now risen above 1%. On an optimistic view of the recovery and given the supply issues (discussed below) our own US rates strategist, Subadra Rajappa, quite reasonably expects US 10y yields to continue rising to 1.5% this year. Personally, I find this *impossible* though - because the equity market will collapse long before we reach 1.5%.

US 10y yields at 1% are in the middle of their long-term downtrend range

Source: Reuters

US bond yields have been drifting higher in recent weeks driven by a combination of hopes of a strong economic rebound later this year as the vaccine allows a return to normality, an increasing cohort of economists believing inflation could rise rapidly, and finally on the realisation that the market has to absorb a huge supply of Treasury issuance at the longer end. The bond supply situation is particularly worryingly high for this year as explained by Colby Smith in the FT, with this shocking chart from the article doing the rounds on Twitter this week – article here.

US Treasury bond issuance (ex bills) is going to be massive this year (net of Fed purchases)



Source: FT

Our US rates strategist writes *"The Federal deficit and Treasury issuance are breaking records. With deficits set to exceed $2.4tn in FY21 and $1.3tn in FY22, Federal debt as a percentage of GDP is expected to surpass WWII levels. Since mid-March, the Fed has purchased $2.0tn of Treasuries, reducing the pressure on markets to absorb the additional supply. Nonetheless, the pressure on markets to absorb long-end supply is palpable as auction metrics continue to deteriorate."* - link

My former Kleinwort colleague Ed Ballsdon analysed the 2021 issuance time-bomb data in his blog last night here. He concludes, "*The investor ramifications from this upcoming long-dated debt issuance are huge. If the private sector has to finance this forthcoming tsunami of coupon issuance, you can bet that real yields will have to rise to attract those private sector savings away from private sector assets.* ***This is exactly what 2018 was all about*** *- real yields rose and stocks and corporate bonds got clobbered until the Fed reversed its tapering exercise and started buying USTs in size.*

Given the supply next year [in 2021], it is fair to say that Central Bank QE had better NOT be temporary in nature, otherwise risk assets could move in a similar fashion to 4Q 2018 *(when there was the terrible combination of large debt issuance, Fed unwinding its balance sheet and rising real yields). My guess is the Fed and other Central Banks will continue to buy substantial amounts of debt, raising the question of what the word 'Temporary' actually means.*

The bond market's increasing jitters about a tsunami of issuance were not just exacerbated this week by the Democrat success in the Georgia Senate race, but also from comments made by the Atlanta Fed. I must admit when I saw the title "**Fed's Bostic says bond-buying 'recalibration' could happen in 2021",** I assumed Bostic was talking about stepping up purchases because of the supply issues above. Instead the Reuters article quoted Bostic saying ***"the Fed could begin to trim its monthly asset purchases this year if the distribution of coronavirus vaccines boosts the economy as expected"***. Wow! No wonder the long end is selling off. (Article here).

Personally, I have never been so hung up on supply as a deciding factor for bond yields. My experience of following Japan closely in the 1990s and 2000s was that the constant refrain about JGB supply driving yields higher was always wrong. If the fundaments in the way of weak growth and deflation justify low bond yields, then massive supply only affects yields at the margin.

In any case I don't believe there is a cat in hell's chance that the Fed can tighten and/or that US 10y yields can rise to 1½%. The equity market bubble will burst long before we get there!

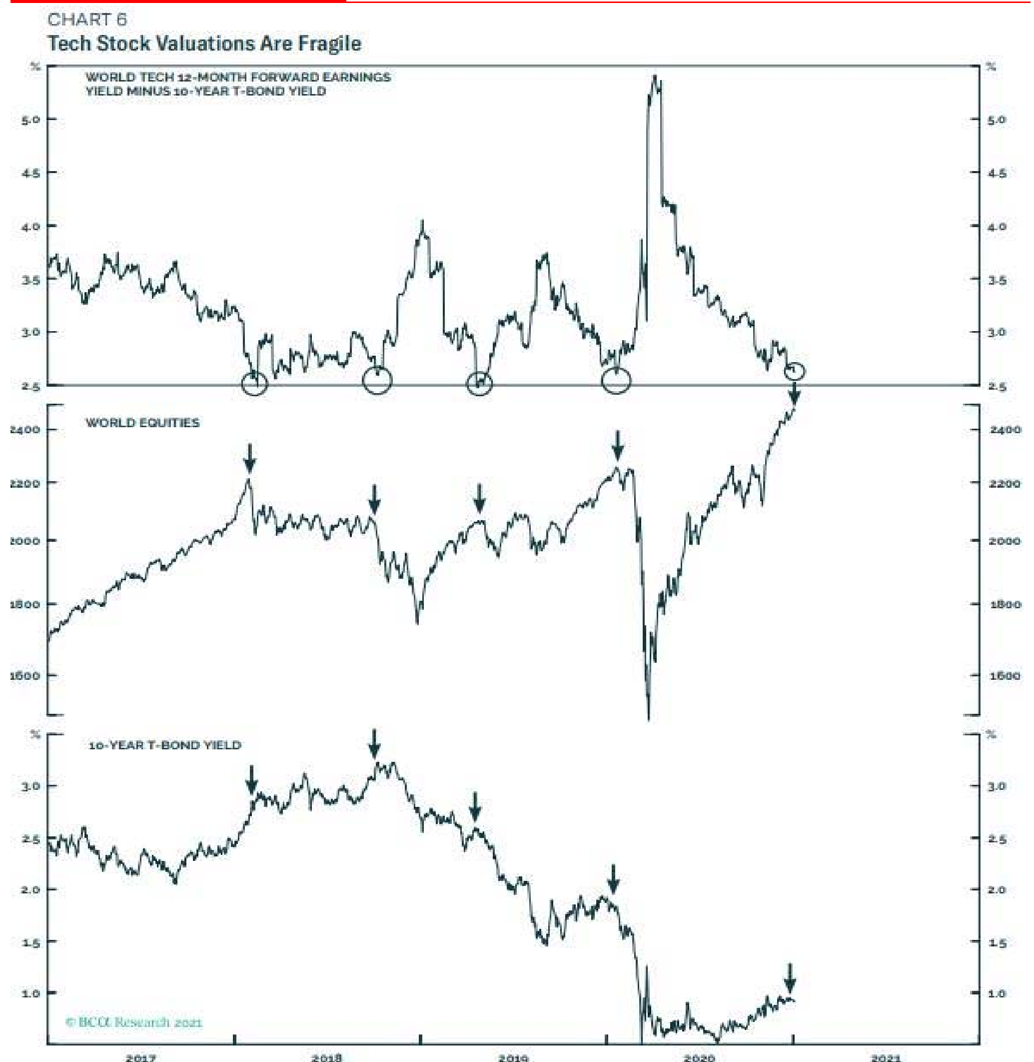
Dhaval Joshi at the Bank Credit Analyst (BCA) writes some excellent research and I have quoted him on these pages before. Dhaval has identified an important tipping point for the ever -inflating tech (FAANG) bubble that has led this equity bull market *"to infinity and beyond".*

Dhaval writes "*Since early 2018, a rise in the long bond yield has sent shudders through the stock market on four occasions: February 2018, October 2018, April 2019, and January 2020. On all four occasions, **the tipping point was the earnings yield premium on tech stocks versus the 10y T-bond yield falling towards its lower limit of 2.5 percent**.*" (see chart below).

With the spike in US 10y yields yesterday above 1%, the danger level 2.5% yield gap Dhaval highlights has now been breached (see chart below).

So even at these much lower bond yields, technology valuations are now stretched beyond breaking point. The US equity market might crack any time now. Of course, if/when it does the Fed will increase QE to implement effective yield curve control to pin the 10y below 1%. But by then it might be too late if an equity market retreat is in full swing and taking on a momentum all of its own. For as Jeremy Grantham points out, this equity bubble will ultimately burst *"no matter how hard the Fed tries to support it".* And that is something many simply cannot comprehend.

Now only 1%+ 10y yields could crack the tech bubble in the same way as 3%+ yields did in Q4 2018



Source: Dhaval Joshi, Bank Credit Analyst

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