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March Monthly Strategy

Don’t panic over rising bond yield

The rise in U.S. Treasury yields has caused fluctuations in global stock markets recently. We argue that stock investors need not be too worried over higher bond yields. Sector allocation may play a key role here: prefer cyclicals over growth.

- **Higher bond yield reflects better economic growth.** Treasury yields usually move in tandem with U.S. GDP growth rate and manufacturing PMI. The rise in bond yields in recent months is a result of vaccination-driven economic recovery and higher inflation expectations due to strong commodity prices.
- **Bonds yields are still quite low and real yields negative.** After the recent rebound, Treasury yields are still at the trough over the past decade. More importantly, real yields (inflation-adjusted) are still negative in major developed countries, which means businesses and consumers should not be discouraged from borrowing by positive real yield. Negative real yield is also a supportive factor for equities, as U.S. equities usually did well as long as real yield on 2-year Treasury stayed negative.
- **Fed’s “average inflation targeting” means no rate hike for years.** Inflations will possibly rise further in the months ahead, but since the Fed has now adopted an inflation target of “averaging 2% over time”, and Fed Chair expects the increase in inflation should be short-lived and reiterates to keep monetary policy highly accommodative, we believe a repeat of "taper tantrum" is unlikely.
- **Stock prices tend to rise along with bond yields.** Empirical evidence shows that stock prices have been positively correlated with bond yields. There could be some divergence over short periods, but over the medium term (3-6 months), they were positively correlated for most of the time.
- **Expect cyclicals to extent outperformance.** Cyclicals started to outperform growth stocks since Sep-Nov 2020, and we believe they will continue to outperform in coming weeks due to: 1) Vaccinations improve outlook of global economy and thereby earnings of cyclicals; 2) Higher bond yields and expected inflations are more favourable to cyclicals; 3) Cyclicals are still extremely cheap compared to growth stocks; 4) Southbound net buying of HK stocks have sharply decreased, putting downward pressure on growth stocks which were favoured by Mainland investors.
- **HSI may remain volatile but range-bound.** As we expect cyclicals to outperform while growth sector be under pressure, they may somewhat offset each other in their contribution to indexes’ performance. Expect the HSI to be range-bound in 28,000-31,000 in coming weeks. Volatility of benchmark indexes will probably remain high, as FY20 and 1Q21 results could bring extra fluctuations.

Preferred sectors and stocks

Sector	Company
Insurance	China Life (2628 HK)
Property	CR Land (1109 HK), Shimao (813 HK), KWG (1813 HK)
Capital goods	Zoomlion (1157 HK / 000157 CH), Jiangsu Hengli (601100 CH), Weichai Power (2338 HK / 000338 CH)

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Market Data

Hang Seng Index	29,096
52-week High / Low	31,183/21,139
3-month avg. daily t/o	HK$204.8bn

Source: Bloomberg

Indices Performance

	HSI	HSCEI
1-month	-0.5%	-2.1%
3-month	9.7%	7.4%
6-month	15.8%	13.6%

Source: Bloomberg

12-month HSI Performance

Source: Bloomberg

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Bond yield rising

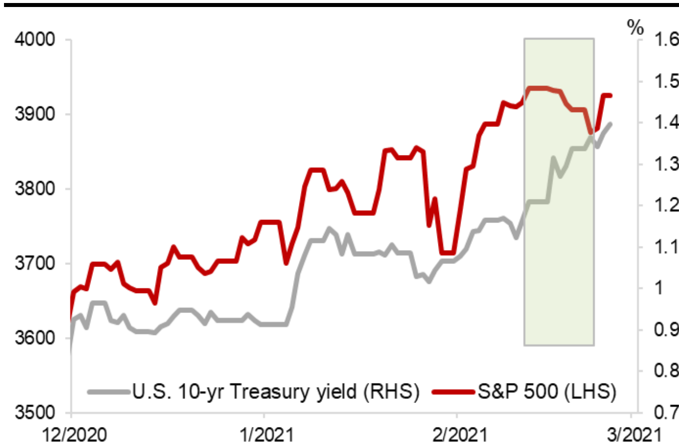
The recent rapid rise in U.S. Treasury yields has become a cause for concern for some stock investors. The corrections in the S&P 500 Index in mid-Feb and subsequently in Asia Pacific markets were partly attributed to the rising bond yield (Fig. 1).

Why stock investors may be worried?

Higher bond yield means:

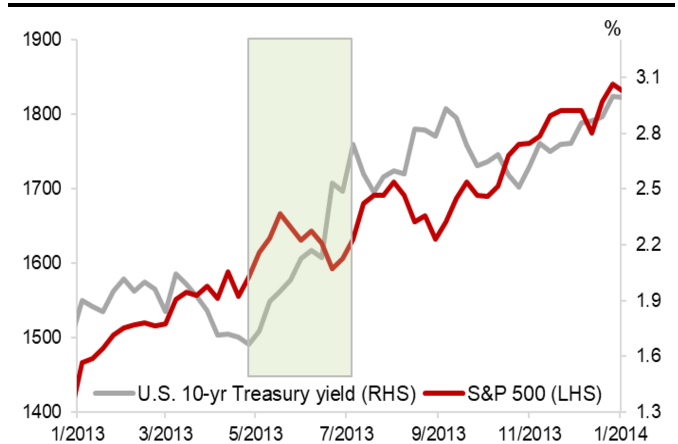
1. **Bonds' relative attractiveness versus stocks increases**.
2. **Higher discount rates** in valuing stocks, particularly some growth companies valued using DCF model.
3. **Higher borrowing costs** may hurt economic growth and corporate earnings.
4. Reflecting **higher inflations which translate to higher costs** for certain industries and consumers.
5. Anticipation of **monetary policies may become less accommodative**, e.g. the Fed might taper QE and raise interest rates. We were there before, during the "taper tantrum" in mid-2013, when the U.S. Treasury yields surged from 1.7% to 2.7% in the space of two months (Fig. 2), after the Fed's announced plans to taper its asset purchase in future. The S&P 500 suffered a 5% correction in that period.

Figure 1: S&P 500 vs U.S. 10-yr Treasury yield



Source: Bloomberg, CMBIS

Figure 2: S&P 500 vs UST yield in 2013



Source: Bloomberg, CMBIS

Why stock investors should NOT be too worried after all?

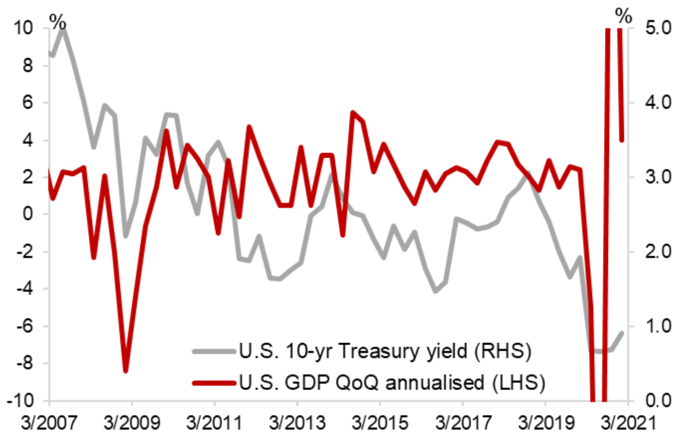
1. **Higher bond yield is a result of improving economic growth** and diminishing deflation risks.
2. Bonds yields are still quite low, and **real yields are still negative** in many countries.
3. Fed's "average inflation targeting" means **no rate hike for years to come**.
4. Historical performance show **stock prices tend to rise along with bond yields**.

1. Higher bond yield is a result of improving economic growth and diminishing deflation risks

More often than not, Treasury yields move in tandem with U.S. GDP growth rate (Fig. 3) and manufacturing PMI (Fig. 4). As economic growth improves, investors tend to shift from defensive assets (bonds) to risky assets (stocks) in pursuit of higher returns, resulting in higher bond yields.

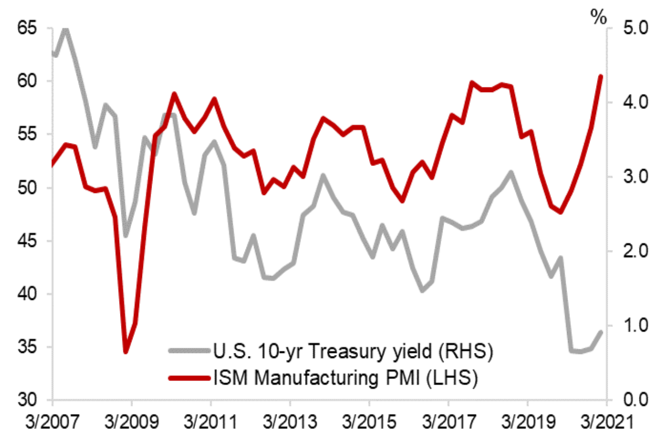
The rise in bond yields in recent months is a result of, in our view, a combination of a better global economic outlook boosted by vaccinations and higher inflation expectations due to strength in oil and metal prices. While higher inflation expectations may stoke fears of monetary policy tightening, there is little imminent risk of tightening, as we will argue in the following.

Figure 3: U.S. GDP growth vs Treasury yield



Source: Bloomberg, CMBIS

Figure 4: U.S. ISM PMI vs Treasury yield



Source: Bloomberg, CMBIS

2. Bonds yields are still quite low, real yields are still negative

At the end of 2020, U.S. 10-year Treasury yield was 0.92%. It is now 1.43%, a 50%+ surge from a low base. While the percentage change is undeniably large, the absolute level is still very low, right at the trough since the 2008 Global Financial Crisis (excluding COVID-19 period) (Fig. 5). The trend of 30-year Treasury yield is similar (Fig. 6).

Not only nominal yields are low, more importantly, real yields (inflation-adjusted) are still in negative territory in major developed countries' sovereign bonds (Fig. 7). If real yields rise to positive, businesses and consumers may feel more reluctant to borrow, which is bad for economic growth. But currently there is no such risks given real yields are still negative.

Negative real yield is also a supportive factor for equities. Over the past decade, U.S. equities usually performed well as long as real yield on 2-year U.S. Treasury stayed in negative territory. In contrast, on the several occasions when 2-year real yield rose to positive, U.S. equities had deeper and more prolonged corrections (Fig. 8). With 2-year real/nominal yields currently at -0.34%/0.12%, it seems very unlikely for real yield to turn positive in the next few months. In other words, **bond yields are unlikely to rise to a level which will cause a major correction in stocks**.

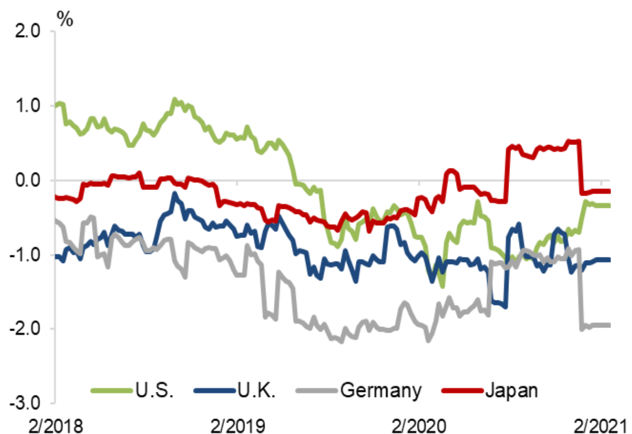
Figure 5: U.S. 10-yr yield near pre-pandemic low

Source: Bloomberg, CMBIS

Figure 6: U.S. 30-yr yield near pre-pandemic low

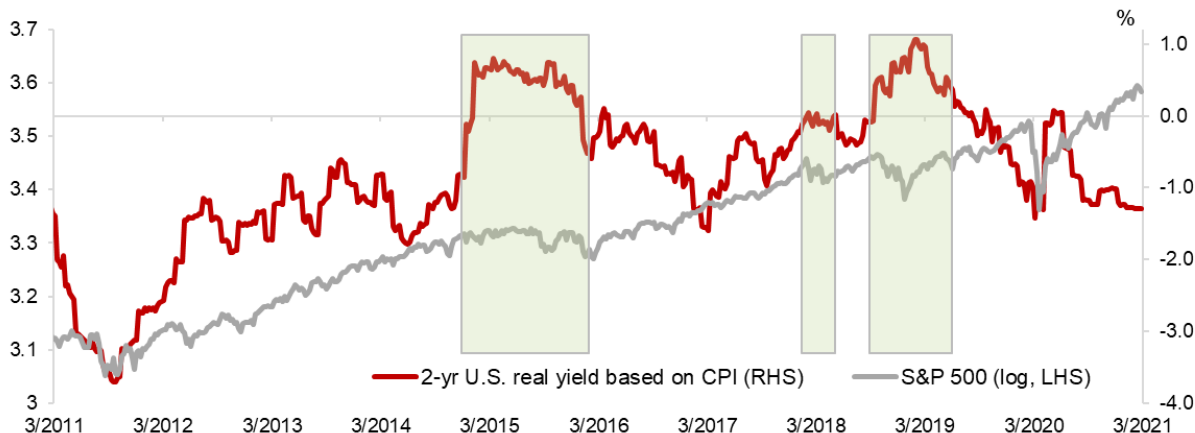
Source: Bloomberg, CMBIS

Figure 7: 10-yr real bond yields are still negative



Source: Bloomberg, CMBIS

Figure 8: U.S. stocks suffered when 2-year real yield turned positive



Source: Bloomberg, CMBIS

3. Fed's "average inflation targeting" means no rate hike for years

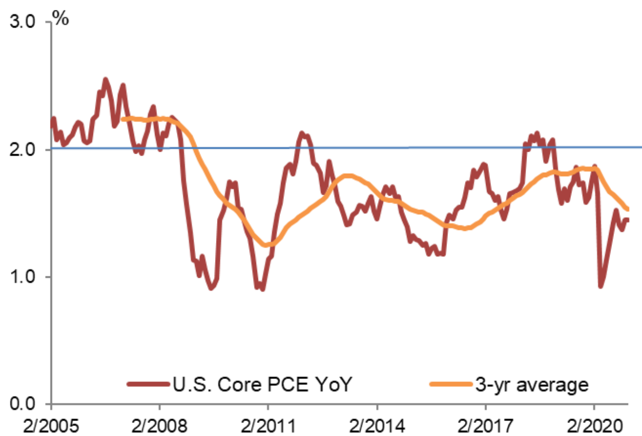
Inflations will possibly rise further in the months ahead, partly due to low base, and partly due to post-lockdown resurgent demand while supply remains constrained. But central banks and investors seem to agree that elevated inflations will be short-lived.

At the U.S. Federal Reserve's meeting on 16 Sep 2020, the Fed announced a policy shift to "average inflation targeting", i.e. a target of "inflation averages 2% over time and longer-term inflation expectations remain well anchored at 2%". With inflation running persistently below this longer-run goal (Fig. 9), the Fed "will aim to achieve inflation moderately above 2% for some time."

In a testimony to Congress in early Feb, Fed Chair Jerome Powell played down the risks of high inflation. He said inflation would pick up in coming months due to low base a year ago, but the increase in inflation was unlikely to be large or long-lasting. This is an important assurance that **the Fed will keep the Fed funds rate and monthly QE amount unchanged for some time**, in stark contrast to the taper tantrum in May 2013 when then Fed Chair Ben Bernanke signalled to wind down QE soon.

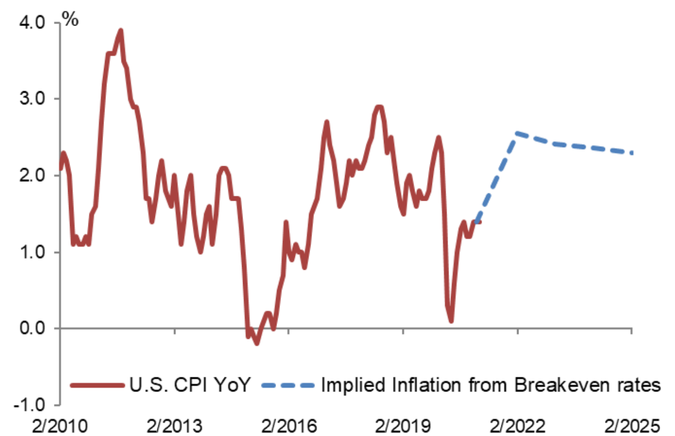
The market apparently agrees that inflations will not keep rising for long. U.S. breakeven rates, derived from U.S. Treasury Inflation-Protected Securities (TIPS), implies that investors expect U.S. CPI inflation to peak a year later at 2.55%, and then trend down in each of the following three years (Fig. 10). In the past when the Fed's inflation target was simply 2%, these expected inflation levels could stoke fears of rate hikes, but with the new "average inflation target", the target won't be reached at least until Q4 2022, based on the latest breakeven rates and using three-year average as a gauge.

Figure 9: U.S. inflation below 2% target since 2008



Source: Bloomberg, CMBIS

Figure 10: Implied inflation to peak in 1 year



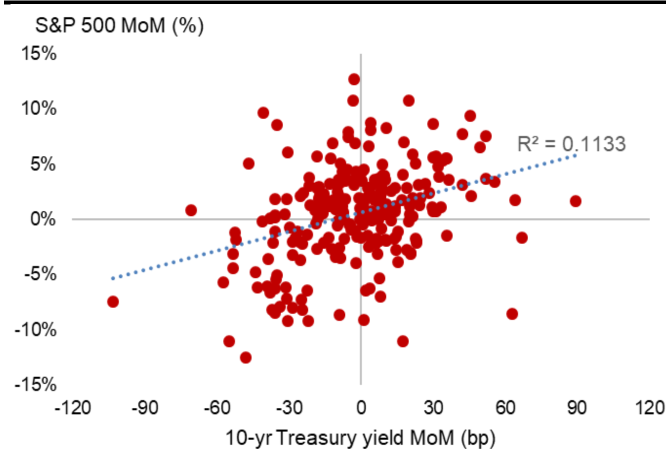
Source: Bloomberg, CMBIS

4. Stock prices tend to rise along with bond yields

Empirical evidence shows that **stock prices have been positively correlated with bond yields** (Fig. 11), i.e. stocks tended to rise when yields rose. There could be some divergence over short periods, but over the medium term (3-6 months), they were positively correlated for most of the time (Fig. 12). In other words, stock and bond prices are negatively correlated. This is perfectly in line with textbook theory.

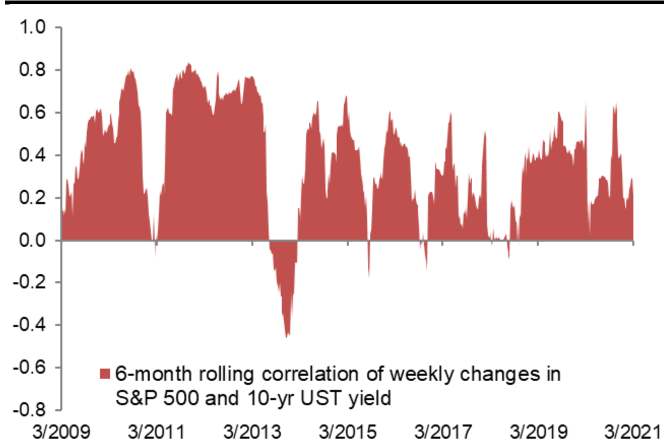
Over the last decade, there was one notable exception when bond yield went north but stock price went south. That was the “taper tantrum” in 2013. But we believe a repeat of that exception is quite unlikely this time, because the Fed has, as we have explained above, changed its inflation target and reiterated that monetary policy would stay highly accommodative for some time (vs. signalling to reduce asset purchase in 2013).

Figure 11: Scatter plot of U.S. stocks & bond yield



Source: Bloomberg, CMBIS

Figure 12: Stock price & bond yield +ve correlation



Source: Bloomberg, CMBIS

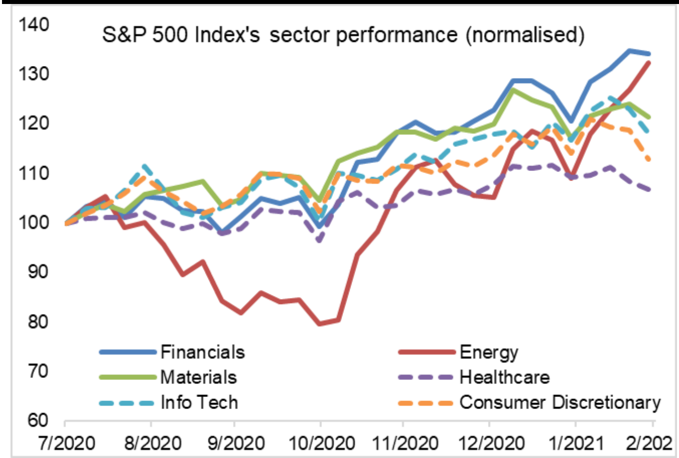
Sectors that outperform when bond yield rises

Since U.S. Treasury yield bottomed out in Aug 2020, U.S. cyclical stocks (financials, energy, material) have outperformed growth stocks (IT, consumer, healthcare) (Fig. 13), reversing the trend since the COVID-19 outbreak. YTD, as the surge in bond yields has drawn investors’ attention, financial and energy stocks’ outperformance has been even more obvious (Fig. 14).

However, after a multi-year underperformance by cyclical stocks, their valuation discount to growth stocks is still at extreme level (Fig. 15). That same is true in HK/China stock market. (Fig. 16).

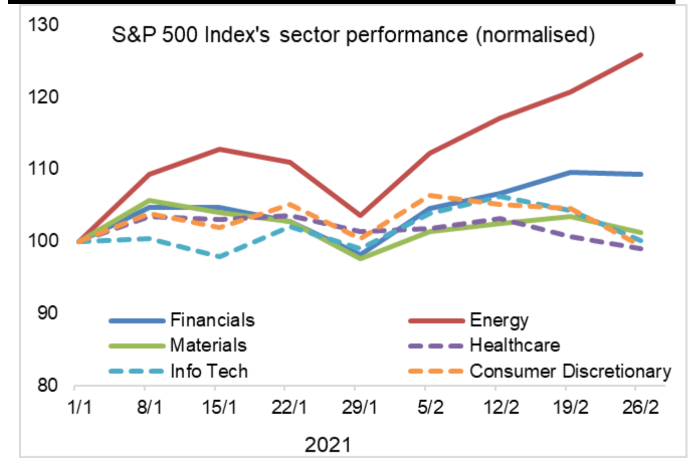
While we do not expect government bond yields to rise much further to levels which could trigger a significant correction in stocks, the fact that bond yields have returned to a more “normal” level has provided the impetus to **further sector rotation from growth stocks to cyclical stocks**. For growth stocks, higher discount rates bode ill for valuations. For cyclicals stocks, financials should benefit from a higher interest rate environment, while energy and material stocks are riding on higher commodity prices and inflation expectations.

Figure 13: Cyclical stocks outperformed since bond yields bottomed out in Aug 2020



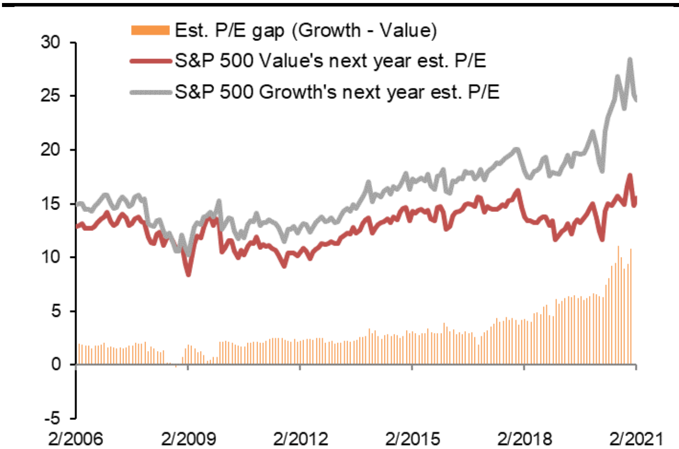
Source: Bloomberg, CMBIS

Figure 14: Cyclicals outperformed growth YTD as bond yields rose further



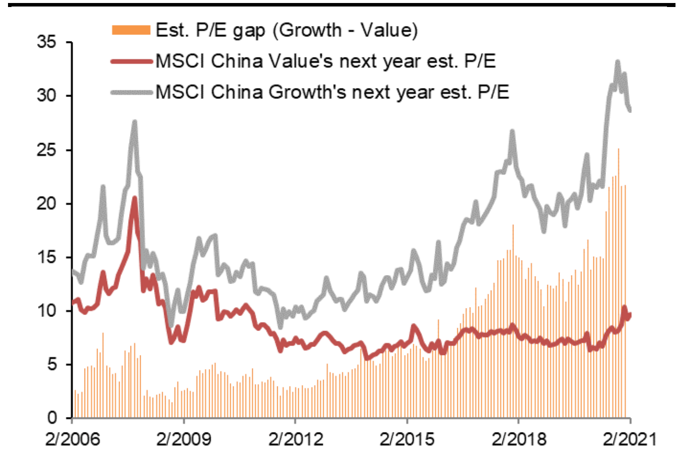
Source: Bloomberg, CMBIS

Figure 15: S&P 500 Value's valuation discount to Growth still at extreme level



Source: Bloomberg, CMBIS

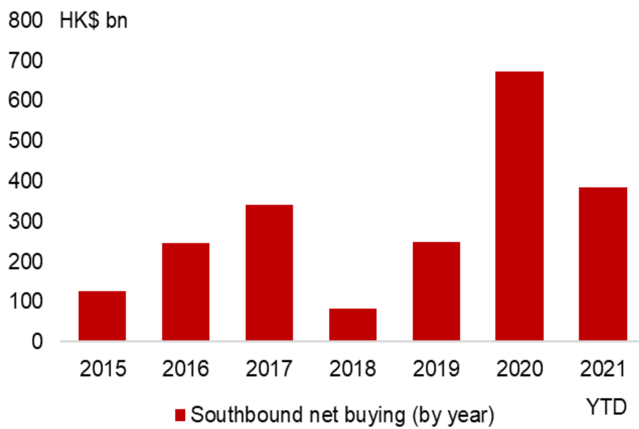
Figure 16: MSCI China Value's valuation discount to Growth still at extreme level



Source: Bloomberg, CMBIS

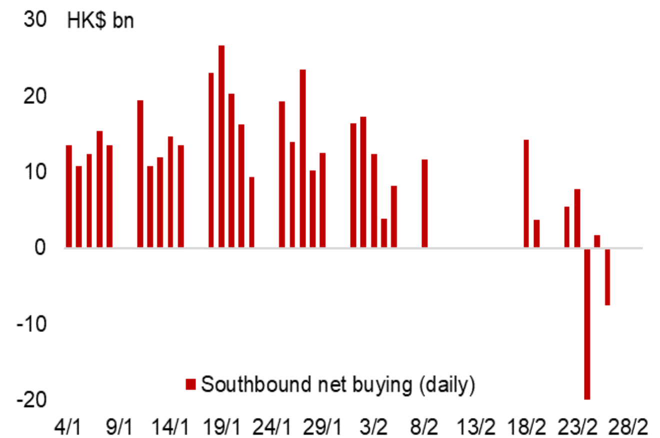
In HK stock market, there is an extra factor that is unfavourable for growth stocks, which is the slowdown in Southbound inflows via Stock Connect. During the strong run in the Hang Seng Index from early-Jan to mid-Feb (HSI +14%), Southbound buying was a major driving force. In Jan alone, Southbound net buying amounted to HK$311bn, equivalent to 46% of the amount in the full year 2020, averaging HK$15.5bn daily. Growth stocks such as internet giants Tencent (700 HK) and Meituan (3690 HK) were consistently among the top traded stocks through Southbound and their stock prices surged to record high. Since the HSI peaked on 18 Feb, however, Southbound inflows have remarkably shrunk to negative (daily average net selling HK$1.3bn). Before Southbound net buying rebounds strongly, growth stocks could face more pressure.

Figure 17: Southbound net buying in HK market



Source: Wind, CMBIS

Figure 18: From net buying to net selling



Source: Wind, CMBIS

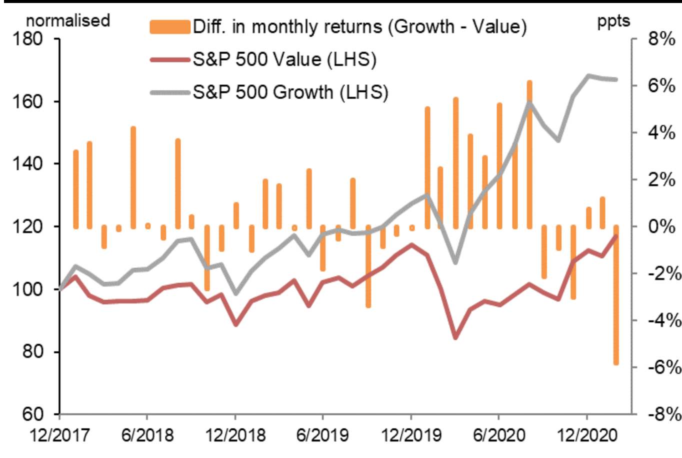
Sector allocation: Cyclicals prevail

Since the outbreak of COVID-19 in Jan 2020, growth stocks in both U.S. and China markets outperformed cyclical stocks, for eight and ten consecutive months respectively, as cyclicals were much more vulnerable to recession. Starting in Sep-Nov 2020, the tide has turned, with cyclicals finally outperforming growth sectors (albeit by a much smaller margin than their underperformance earlier).

We expect cyclicals to extent their outperformance over growth sectors in the coming weeks, thanks to:

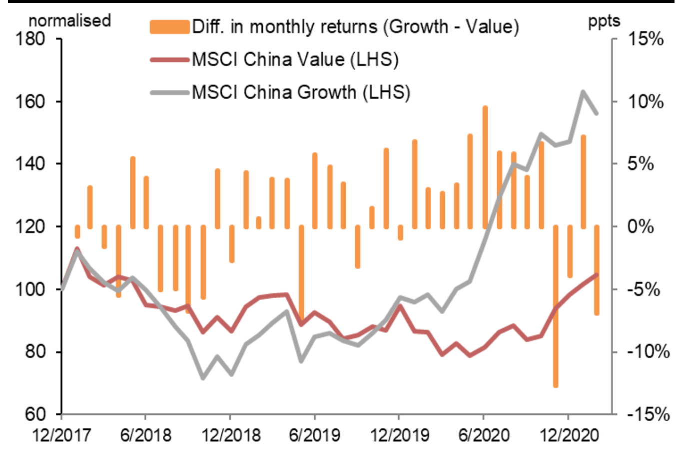
1) Vaccinations improve outlook of global economy and thereby earnings of cyclicals;
2) Higher bond yields and expected inflations are more favourable to cyclicals;
3) Cyclicals are still extremely cheap compared to growth stocks;
4) Southbound net buying of HK stocks have sharply decreased, putting downward pressure on growth stocks which were favoured by Mainland investors.

Figure 19: U.S. cyclical stocks catching up



Source: Bloomberg, CMBIS

Figure 20: China cyclical stocks catching up



Source: Bloomberg, CMBIS

Among cyclicals, we prefer China Insurance, China Property and Construction Machinery sectors. Some of our top picks include:

Figure 21: Preferred sectors and stocks

Sector	Company	Ticker	Rating	Target Price
Insurance	China Life	2628 HK	BUY	HK$28.14
Property	CR Land	1109 CH	BUY	HK$44.79
	Shimao	813 HK	BUY	HK$44.94
	KWG	1813 HK	BUY	HK$17.87
Capital goods	Zoomlion	1157 HK / 000157 CH	BUY	HK$16 / RMB17.8
	Jiangsu Hengli	601100 CH	BUY	RMB143
	Weichai Power	2338 HK / 000338 CH	BUY	Under review

Source: CMBIS

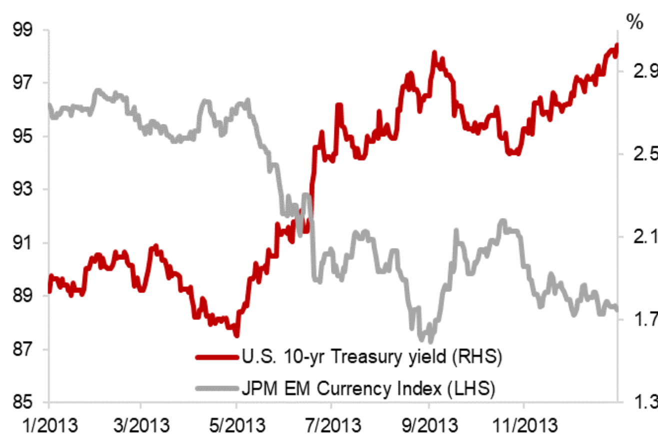
Over medium-to-long term, when the economy normalises, and cyclical industries' YoY profit growth slows down to normal level on higher base, we believe investors will once again prefer growth stocks such as internet, technology and consumer. But in the short term, growth stocks may underperform. Wait for better entry point.

Risks on EM currencies and fund flows

On downside risks to equities, rising U.S. Treasury yields could pose a risk to emerging markets, in terms of fund outflows and currency depreciation.

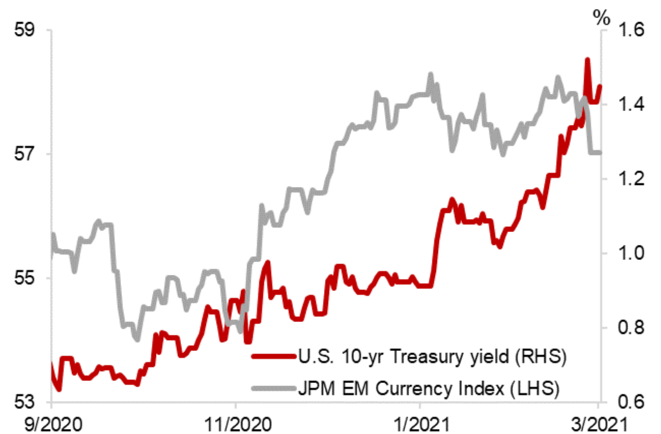
During the taper tantrum in mid-2013, when U.S. Treasury yields surged, EM currencies depreciated sharply (Fig. 22). YTD, EM currencies are showing more volatilities, especially during periods when U.S. Treasury yields were rising (Fig. 23). In case Treasury yields rise further, there could be more fund outflows from EM and more downside in EM currencies which translate into poorer return on EM equities.

Figure 22: Treasury yield vs EM currencies in 2013



Source: Bloomberg, CMBIS

Figure 23: Treasury yield vs EM currencies now



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