Worried about long-term bond yields, this strategist says overweight cash

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By Jules Rimmer

With upward pressure from sticky inflation and deteriorating fiscal outlooks, bond yields threaten to rise over the next six-to-12 months. This explains why independent investment strategists, MRB Partners, recommend maintaining overweight exposure to cash within multi-asset portfolios.

A note published by the firm pointed out an interesting feature of the last decade is that developed market government bonds have been unable to outperform cash returns, as measured by the gap between 10-year notes BX:TMUBMUSD10Y and 3-month bills BX:TMUBMUSD03M.

Based on MRB research, fixed-income "investors are still too complacent on the long-run [developed market] inflation outlook, especially in the market-leading U.S."

The MRB research team emphasizes the resilience of the global economy in taking up their tactical equity weighting to neutral, reversing the shift to underweight made in March. That said, they anticipate limited upside for stocks because rising bond yields depress valuations - a function of higher discount rates lowering the present value of future cash flows.

While MRB regard the ongoing trade disputes "as an irritant rather than a major risk to U.S or global economic growth," they are at pains to stress "we are not sanguine about the capital markets outlook." Economic conditions in the U.S are "late cycle," U.S. equities are "expensive in aggregate" and the upward trajectory of bond yields is a major concern.

The S&P 500 has underperformed most other stock markets this year, with the U.S. index SPX up 2% vs. the 16% rise in the iShares MSCI ACWI ex-U.S. ETF ACWX.

The problem for fixed-income investors is well-established by now and MRB cite upside risks to inflation, the worsening fiscal situation and accommodative monetary policy as the factors that will eventually drive U.S. bond yields BX:TMUBMUSD30Y above 5%.

While acknowledging the timing of this is unclear, if/ when this eventuates, there will be adverse spillover effects and markets will be much more anxious about the sustainability of global economic expansion, the firm says.

This concern is what warrants a neutral approach to equities despite the durability of the U.S. consumer and the doggedness of U.S. growth. For bond portfolios, MRB advises underweight duration (instruments with longer-date maturities) and discern better value in corporate credit and local currency emerging market debt.

Discussing the uncertainty posed by the tariffs dispute, MRB predicts "neither hard nor soft data will provide reliable signals about near-term economic performance," mostly owing to the unpredictability of timing major deals and announcements. Nonetheless, U.S. financial conditions remain easy and so global equities will have a positive bias so long as bond markets behave well.

Such a trading environment, MRB says, means gold (GC00) will continue to have tailwinds and the team forecasts further depreciation for the dollar DXY as investors diversify away from U.S. assets. This informs the "mild U.S. underweight" within global equity portfolios, in favor of the eurozone, Japan EWJ and emerging markets EEM.

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