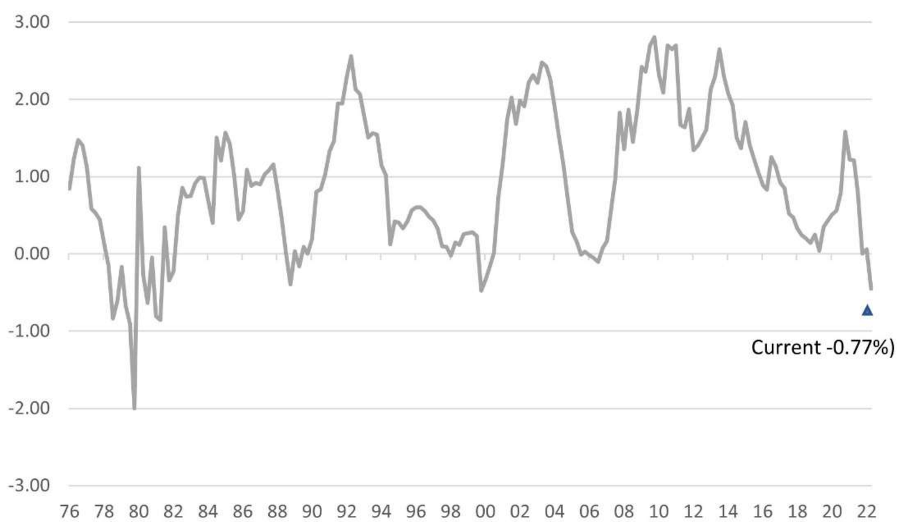
November 28th, 2022

Managing Tail Risks – US Government Bonds and the Oil price

- **Extraordinary inversion of the US yield curve**
- **We believe it is more likely that the US 10-year government bond yield moves back to the 4.00%-4.25%**
- **We prefer short duration**
- **We warn investors not to underestimate the risk to the upside for the oil price**
- **We expect Russia/OPEC to protect the oil price from any precipitous fall**
- **Russia may also weaponise its oil production to cause much higher oil prices**
- **We remain long the oil sector**

Judging by history, the US yield curve has an extraordinary inversion. But what does it mean? Extraordinary, because since 1976 there have been only 21 quarters when the yield curve turned negative, which is equivalent to 11% of all quarters since then. However, if we exclude the high inflation period of 1978-1982, which accounted for 14 of those 21 quarters, we are left with just seven quarters out of the 170 when the yield curve was negative, or just about 4.1% of the time. Truly, these are unprecedented times.

Chart 1: Steepness of the US Government bond curve, 10-year bond yield versus the 2-year bond yield (%)



Source: Bloomberg

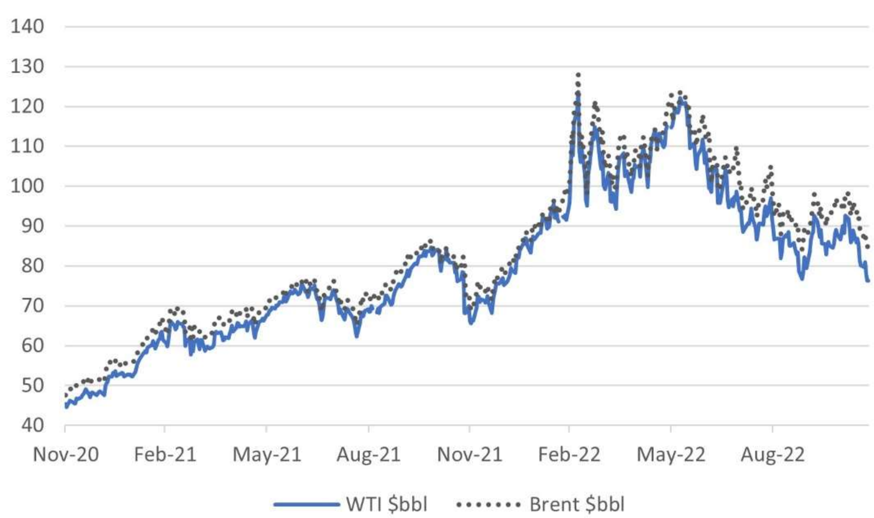
How does the market – and we – see it?
Our interpretation is that investors are pricing in a sharp increase in the Fed funds rate and that these Fed's rate increases, will rapidly diminish the inflation risk. Hence the high two-year bond yield discounts the likely Fed fund rate increases, and the 10-year bond yield discounts the market's expectation that Fed action will be decisive in bringing inflation down at a rapid pace.

We believe the market is far too optimistic in pricing in the likely effectiveness of the Fed policy. It's almost pricing in a perfect scenario. The risk to that optimism is that the market reprices, unwinding the extraordinary inversion of the curve through a sharp increase in the 10-year government bond yield. The average steepness of the curve since 1976 has been 90bps compared with the negative 77bps at present. Hence a reversion of the yield curve to that average steepness level implies an adjustment of approximately 170bps from the current levels. We believe the significant risk is that the 10-year yield must rise by a good share of the 170bps, taking the yield way back above the recent peak of 4.24% from today's 3.68%.

We are also of the view that the Fed may have to raise the rates above 5% before it has the measure of the inflation threat. We have listened to more considered academic views on the necessary level of rates, and the opinion is that the risks are all to the upside on where the Fed funds rate peaks – perhaps somewhere in the 5.25% to 5.75% region. That could also mean a 6-8% unemployment rate, and not 5%. And, if at all you thought inflation was transitory, Apple TV+ recently announced a staggering 40% increase in its monthly subscription price!

Oil prices – risks to the upside
OPEC + meets on December 4th, and the members remain focussed on stabilising prices in a range that they feel comfortable with, i.e., $85 to $95. Brent oil prices have just dropped out of the lower end of that range; hence there will likely be pressure to maintain the daily production cut of 2 million barrels. In the recent silly season of rumours in the financial markets, there was a suggestion that OPEC+ would increase output by 500,000 bpd, but Saudis were quick to quash those rumours, suggesting, to the contrary, that they may push for a production cut.

Chart 2: Oil prices at crucial support



Source: Bloomberg

While many commentators argue that oil prices must weaken from here given the likely slowdown in global demand in line with the drop in global growth, we do not agree with that view. Even if they fail to push oil prices substantially higher, we see a few crucial factors at least working in favour of the oil prices, in certain circumstances.

New EU restrictions on Russian oil
Starting December 5th, new measures from the EU governments will bar EU companies from transporting, insuring, and financing Russian oil shipments, implying deliveries to alternative buyers in India, for example, could take ten times as long. Russia has already been pivoting towards Asian buyers, but those longer supply times for its oil put a strain on logistics requiring more fleet days and extra costs.

JPMorgan recently warned that the likely Russian response to greater EU restrictions on its oil sales could lead to a massive spike in prices. The argument goes that the Russians could cut their production massively – by, say, 3 million barrels a day, which could drive prices, in their view, to $190.

Oil inventories are low
The US has been drawing on its strategic reserves to sell onto the global market, with its aggregate strategic reserves now at their lowest since 1984. Low inventories limit how much further the US will go with a reduction in its reserves.

Oil share prices set for further gains
Despite the drop in oil prices over the past three months, shares in oil companies have surged helping the oil sector rake in decent gains. In current times, it remains one of the few equity sectors that provide some portfolio protection against inflation.

Chart 3: US oil sector ETF and WTI Oil prices (rebased to November 2017=100)

(Index)

Source: Bloomberg

Geopolitics in Iran could still spook the oil market
The current domestic issues in Iran could prompt the Iranian regime to create more troubles on the nuclear front to deflect attention from how it has dealt with the protests at home. Iran has announced that it is increasing the enrichment of uranium to 60%, still well short of the 90% level required for a nuclear device. But just the fact that it is enriching fuel to a still higher quality has unnerved the markets. Military intelligence sources have also suggested that Iran could be just weeks away from developing the fuel for a nuclear weapon. The gap between making a weapon and having the ability to deliver to a battlefield may still be two years apart, though. Still, at the very least, a newly installed prime minister in Israel, Benjamin

Netanyahu, will build up the anti-Iran rhetoric and articulate his red lines concerning Iran's nuclear capability. PM Netanyahu is also aware that Israel could not act alone.

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