Seeking Alpha α

Riding The Storm: Short Long-Term Treasuries, Consider Preferred Shares As A Defensive Position

Jan. 6, 2017 12:12 AM ET16 comments
by: Anton Tyumin

Summary

- U.S. equities continue to face significant near-term correction risks.
- The rally in financials might have been overblown. A brief correction might follow shortly.
- Long-term Treasuries are a pure "Sell" for the medium term. Yield-seeking investors might want to consider investing in preferred stock ETFs.

Market overview

It is true that the opportunity cost of remaining bearish throughout 2016 has been rather high. Nonetheless, despite successfully proposing **financials** (NYSEARCA:XLF) as a potential "long" pick in the first half of September, I have recently turned rather sceptical on the sector. As the SPDR Financials ETF has gotten considerably more expensive since the publication of my analysis, I maintain the view that the sector - and especially the ETF's largest constituents - might have already reached an intermediate top as the market expects the Fed to remain cautious (and slow) with the rate hiking process.

Even though the major U.S. banks will remain a popular trade on the street in the coming months (see Steve Eisman's bullish take here) due to the expectations of Dodd-Frank deregulation and corporate tax rate decreases, many continue to question the extent to which President-elect Trump will be able to deliver on investors' expectations.

Despite the fact that the majority of the largest financial stocks have been trending higher since the December 14 rate hike, a certain momentum slowdown has been a common feature for multiple names, as evidenced by the 3-month charts of the XLF's top 9 holdings (see below).

Source: compiled by the author using the charts provided by YCharts.com

It is true that one shouldn't have waited for elevated trading volumes during the holiday season. Nonetheless, higher volume is now required to sustain the uptrend and keep the ETF above the support level of $23.10. Otherwise, the current state of the financials' rally seems rather fragile to me.

The November 9-14 spike and the consequent decline in trading volumes are highlighted in the chart below. A retest of the SMA50 is more than possible.

Source: StockCharts.com

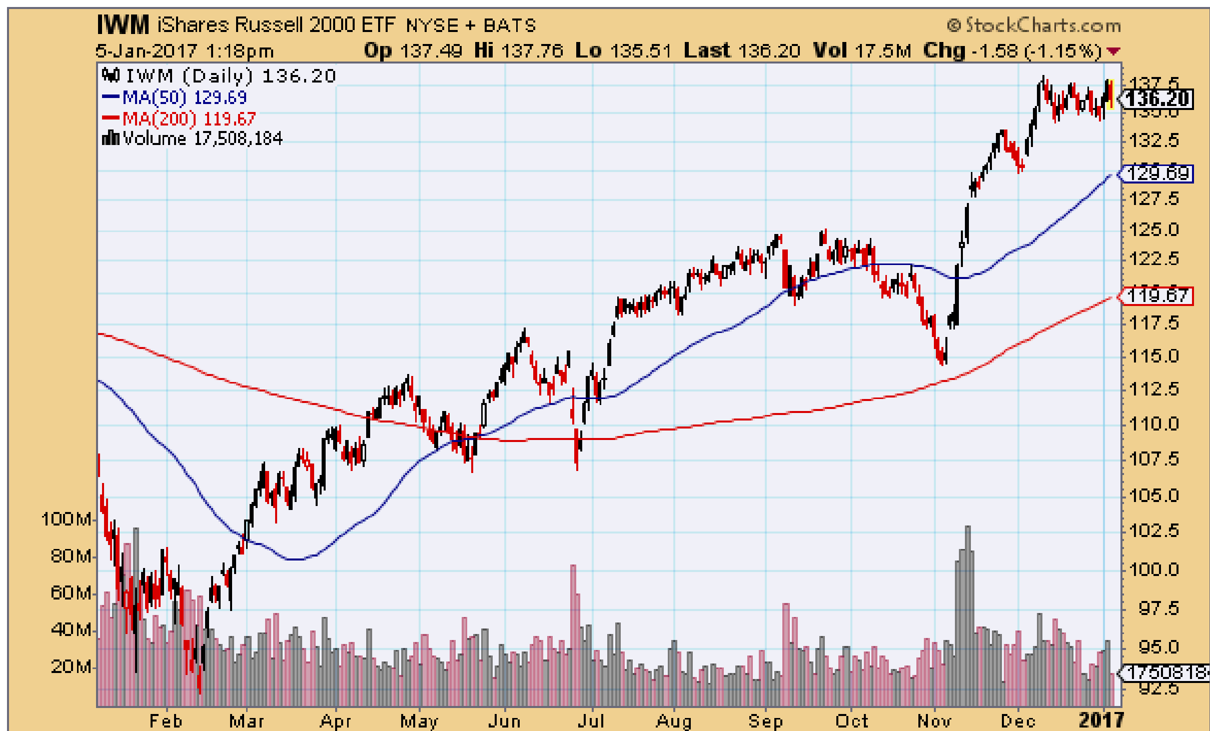
Current narrative

The recent market dynamics have been predominantly centered on 4 broad themes:

- As the U.S. interest rates are set to rise throughout the upcoming years, investors have been busy selecting their top financials and insurance stock picks;
- As a direct consequence of the rising interest rates, the U.S. dollar rally is likely to continue;
- Suggestive of increased investor risk appetite, small caps have been receiving increased levels of attention lately;
- The infrastructure argument of the "Trump rally" continues to favor industrials (NYSEARCA:XLI).

High optimism

While the financials rally has strong support from the fundamentals' standpoint, it is much more challenging to find the data supporting the current risk-on rally in smaller caps.



Source: StockCharts.com

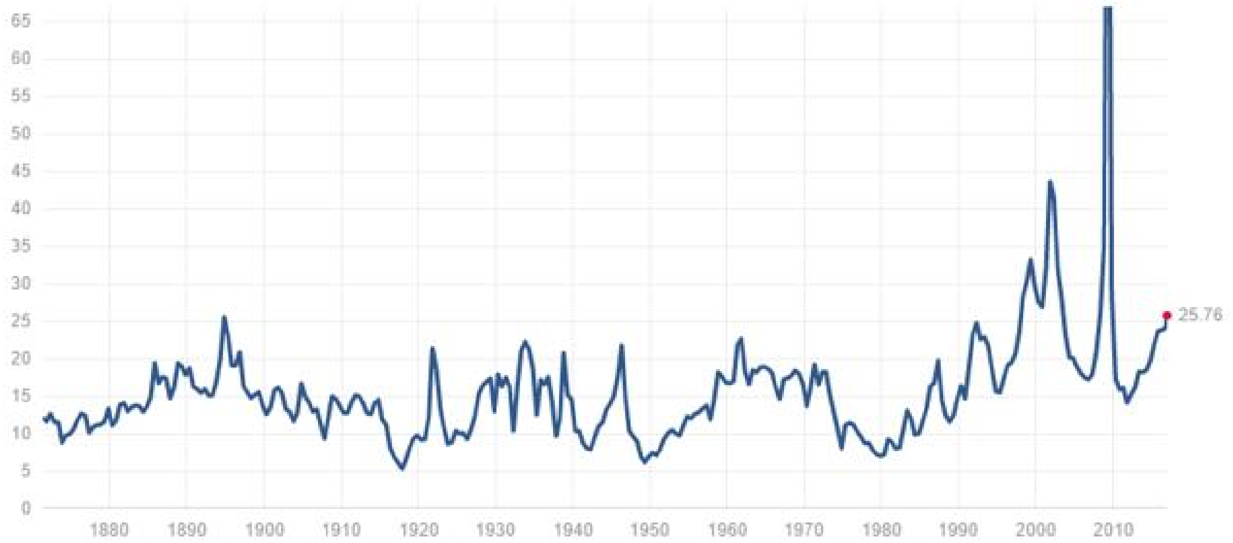
It is true that a *risk-on* sentiment trade - staying long the Russell 2000 (NYSEARCA:IWM) and short gold (NYSEARCA:GLD) - might prove to be a rather profitable trade this year. This, however, would require investor sentiment to stay exceptionally strong. For this to occur, the waters should remain *surprisingly calm:*

- The widely expected Dow 20,000 landmark should be achieved shortly;
- The U.S. economic conditions should continue to favor stock returns;
- No major geopolitical tensions - a significant source of investors' near-term concern - should escalate in the coming months;

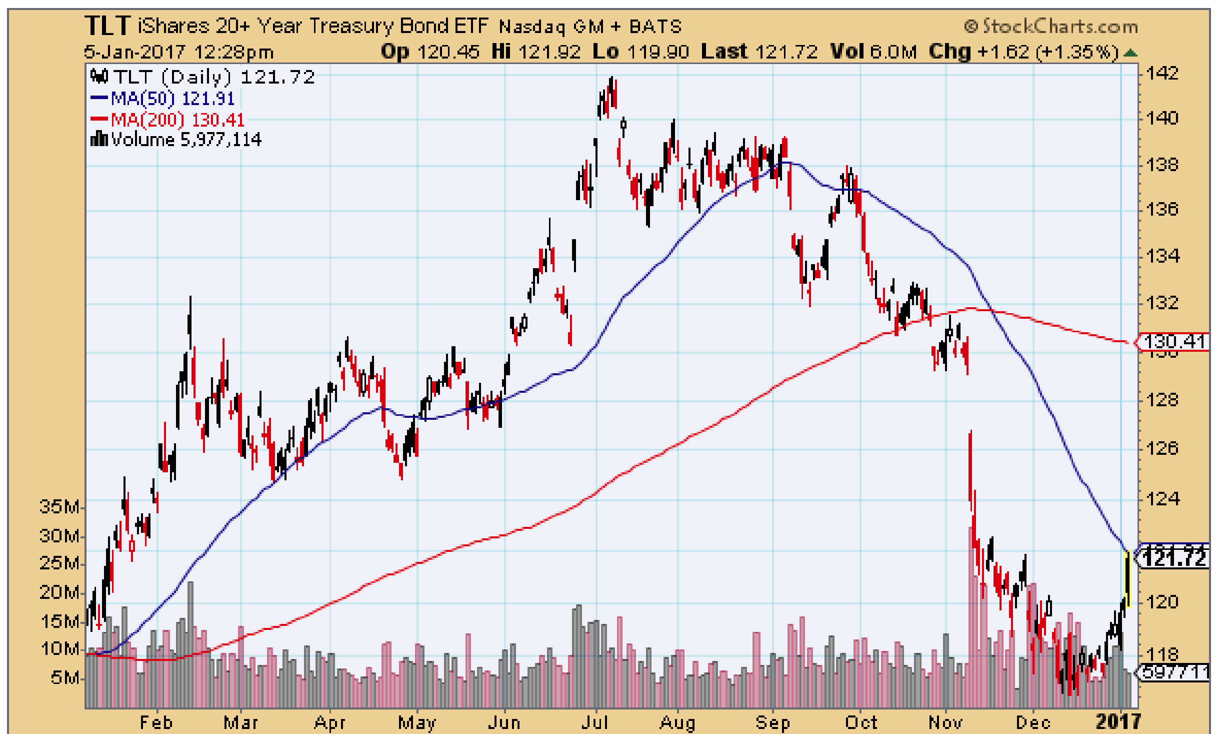
> Rising interest rates should not adversely affect the debt payers' bottom lines and/or fuel bond market selloffs.

Whether the current state of the U.S. stock market may be described as *irrational exuberance* or not, I believe readers can name multiple developments that might prevent the assumptions in this list from happening.

In parallel with that, high equity valuations and underperforming Treasuries (NYSEARCA:TLT), utilities (NYSEARCA:XLU), staples (NYSEARCA:XLP) and precious metals lead to **lower availability of safe haven assets** on the market. As a possible outcome, we are already witnessing a significant *trend reversal in gold*.



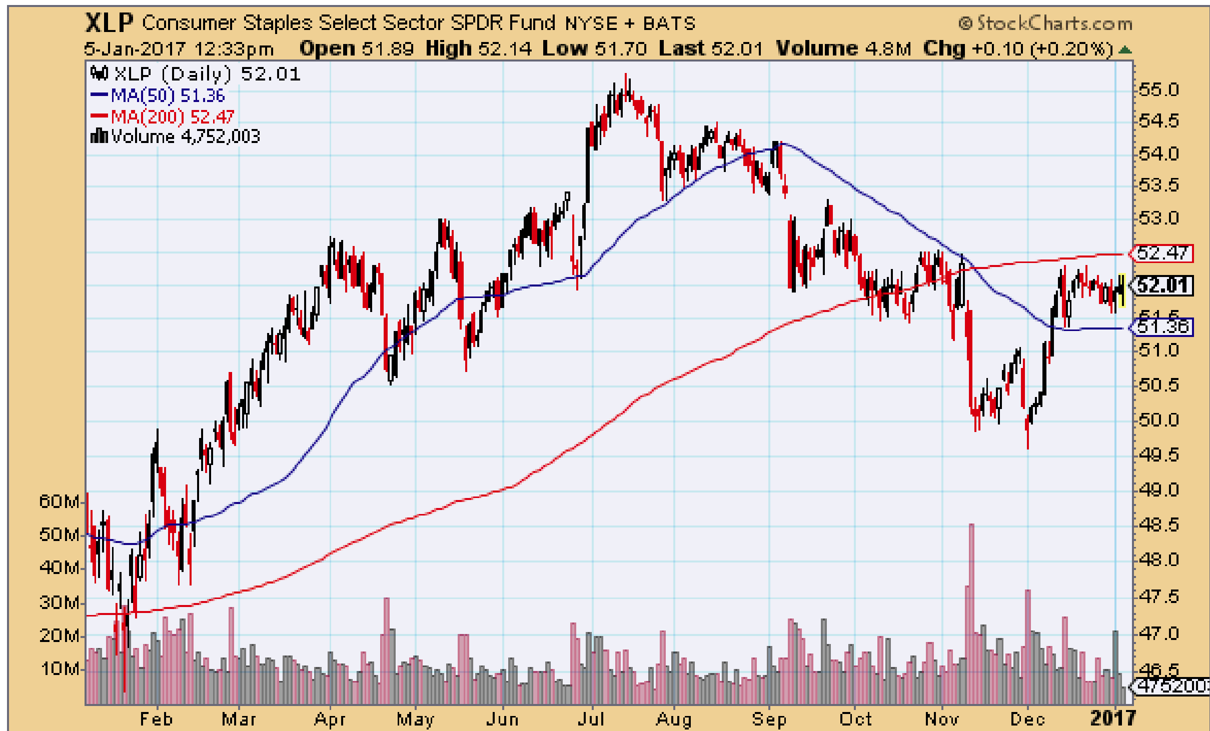
Source: Multpl.com



Source: StockCharts.com

Source: StockCharts.com

Source: StockCharts.com



Source: StockCharts.com

Although the U.S. dollar is expected to stay strong, the gold chart is getting very interesting. The possible retest of the SMA50 could be a turning point for my currently-neutral opinion on gold at these levels.

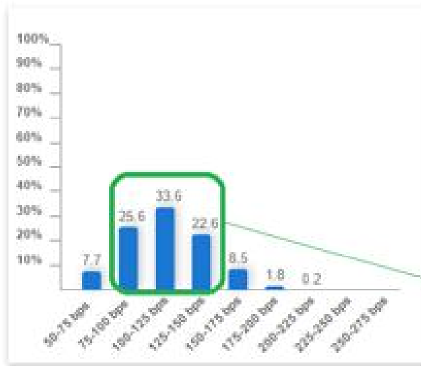
Source: BarCharts

To sum up, lower availability of defensive picks forces me to conclude that the need for hedging the downside risks might be even higher than usual. Long-term Treasury ETFs - a potential short at current conditions - is presented below.

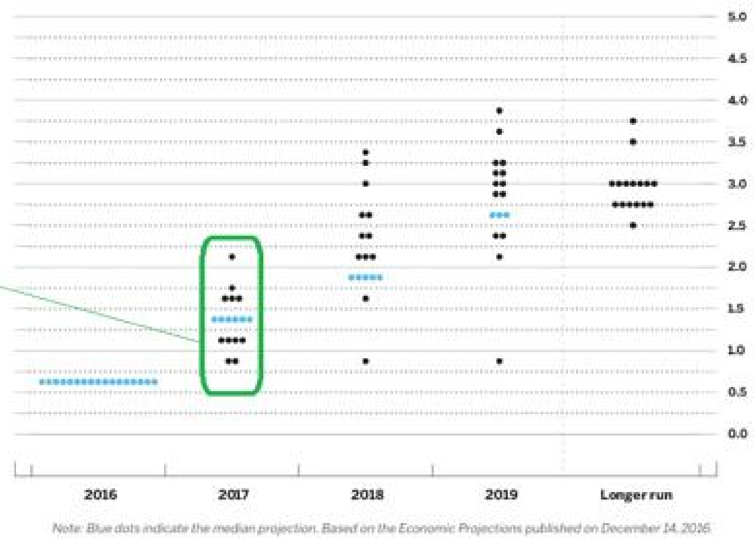
The dot plot: a pessimistic plot for the long-term Treasuries?

Although the market remains quite skeptical on the possibility of another 0.25 percent rate hike up until the Fed's June 14 meeting, the distribution of futures-implied rate hike probabilities for the Dec. 13 meeting closely resembles that of the FOMC participants' dot plot. It is true that both are likely to change throughout the year, and one might even argue that the Fed might choose to accelerate the process in the future. However, even the most anticipated scenario - a 50 bps target rate increase by the end of the year - implies significant downside to long-term Treasuries as demonstrated by the TLT chart below.

Meeting date: Wednesday, 13 Dec 2017



FOMC Participants' Assessments of Appropriate Monetary Policy: "Dot Plot"



Source: CME Group.

Better conditions for hiking?

Meanwhile, another source of pressure comes from the improvements in the global inflation outlook. Jamie McGeever at Reuters writes:

> Upbeat global economic data and growing signs that inflation on both sides of the Atlantic is accelerating fueled a second day of 2017 gains across world stock markets on Wednesday, and lifted the euro and oil prices […] "It will be interesting to see just how much the (incoming Trump administration's) fiscal stimulus plans contributed to the interest rate forecasts from Fed policymakers in December and whether there is potential for the pace to be faster still," said Craig Erlam, senior market analyst at Oanda."

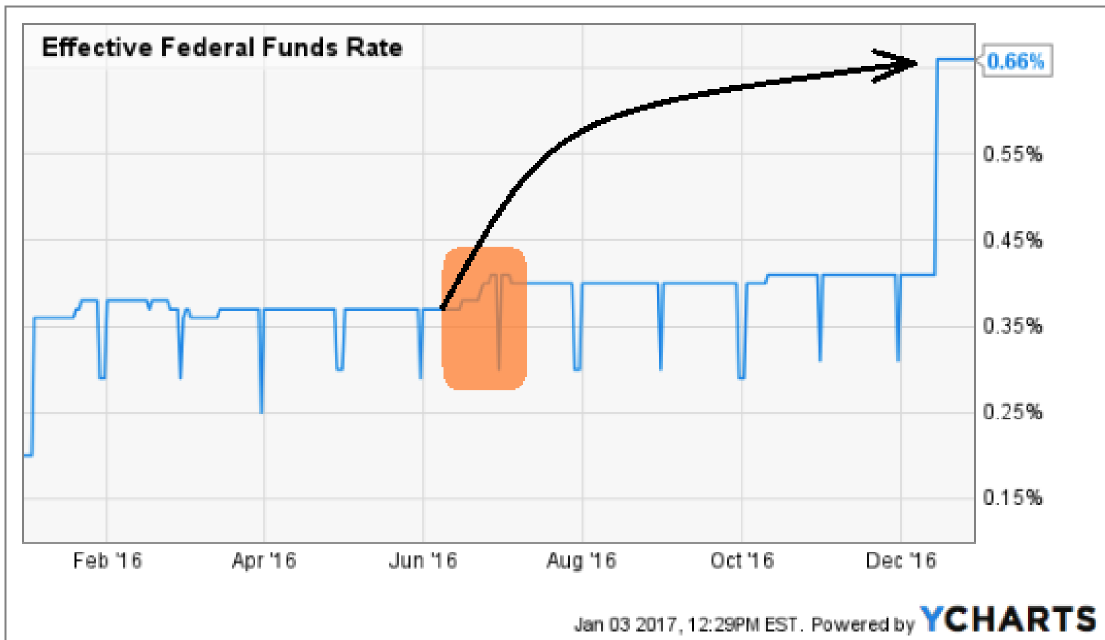
Even though it is too early to conclude that the Fed is likely to accelerate the process, rising commodity prices and improving business and consumer confidence indicators definitely decrease the possibility of the Fed postponing the widely expected 0.5 percent rate hike this year. In addition, here is an important quote from the December 13-14 FOMC minutes:

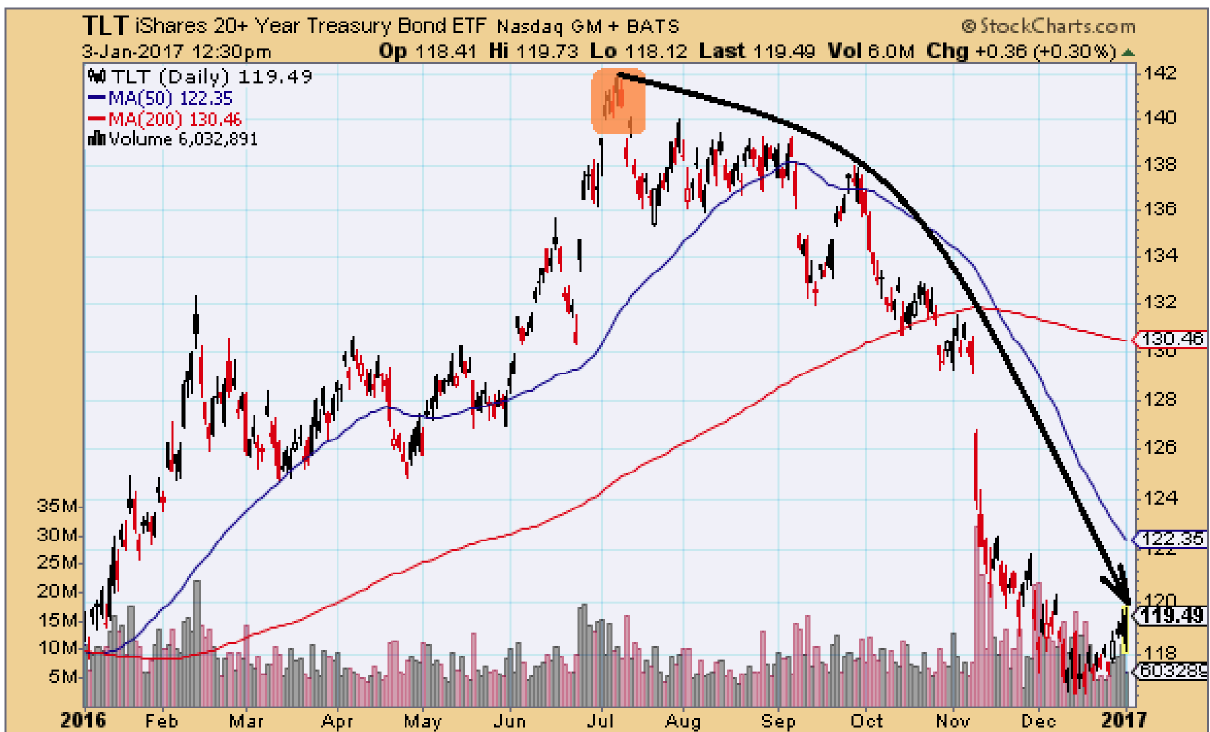
> Many participants judged that the risk of a sizable undershooting of the longer-run normal unemployment rate had increased somewhat and that the Committee might need to raise the federal funds rate more quickly than currently anticipated to limit the degree of undershooting and stem a potential buildup of inflationary pressures. However, with inflation still below the Committee's 2 percent objective, it was noted that downside risks to inflation remained and that a moderate undershooting of the longer-run normal unemployment rate could help return inflation to 2 percent. A couple of participants expressed concern that the Committee's communications about a gradual pace of policy firming might be misunderstood as a commitment to only one or two rate hikes per year; participants agreed that policy would need to respond appropriately to the evolving outlook."

While it is still unclear whether the recent job creation efforts of President-elect Trump could ramp this process up, I maintain the view that recession risks might force the Fed to act quicker than expected at one point.

As a side point, continued Chinese Yuan (NYSEARCA:CYB) pressure might result in further selling of U.S. Treasuries by the PBoC, while additional selling might come from the U.S. banks, primary concern of which would be to prevent the deterioration of the CET1 ratio as a consequence of unrealized losses on fixed income portfolios.

As a result, I conclude that the long-term Treasuries have a lot lower to go in 2017. However, for as long as the majority of the market participants only expect the Fed to come up with another hike in June (a 48.3% futures-implied probability of a 0.25% hike), I would still argue that better shorting entries are likely to follow in the coming quarters.





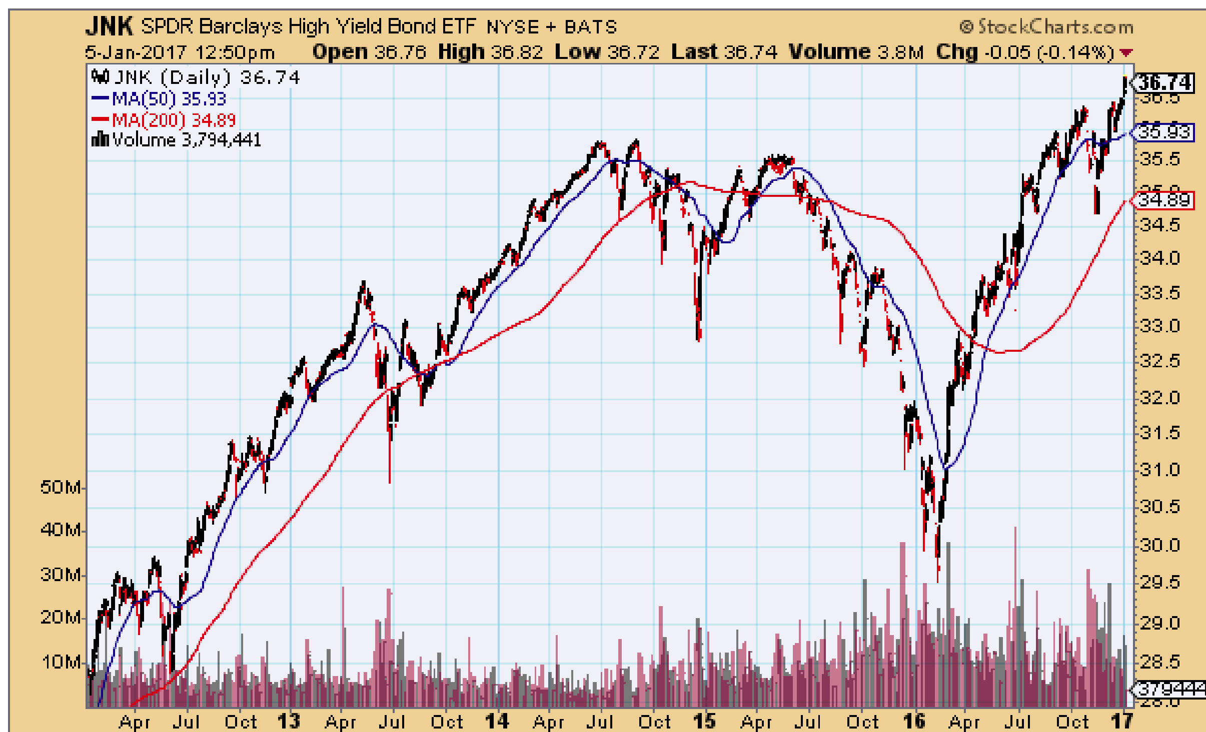
Source: compiled by the author using the charts from StockCharts.com and YCharts.

What about the high-yield bond ETFs?

Acting as an unofficial investor sentiment barometer throughout 2016, high yield bonds (NYSEARCA:JNK) have demonstrated an impressive rally since bottoming in Q1 2016. Although the bankruptcy wave that has shaken the energy sector is less of a threat than it was in 2014-2015, multiple risks continue to prevail (these are *junk* bonds for a reason). Nonetheless, one should not cross out the SPDR high-yield bond ETF from the list right away due to:

- Continued sentiment improvement;
- Moderate modified adjusted duration value of 4.06 (implying 4.06% downside for a 100 bps increase in yield and vice versa);
- Momentum effect;
- Improving U.S. corporate profit dynamics.

While the industrial production downturn remains a primary concern, additional protection comes from the 6% yield. In fact, the distribution-adjusted chart - despite looking scary in the second half of 2015 - doesn't look too bad for the longer-term holders.

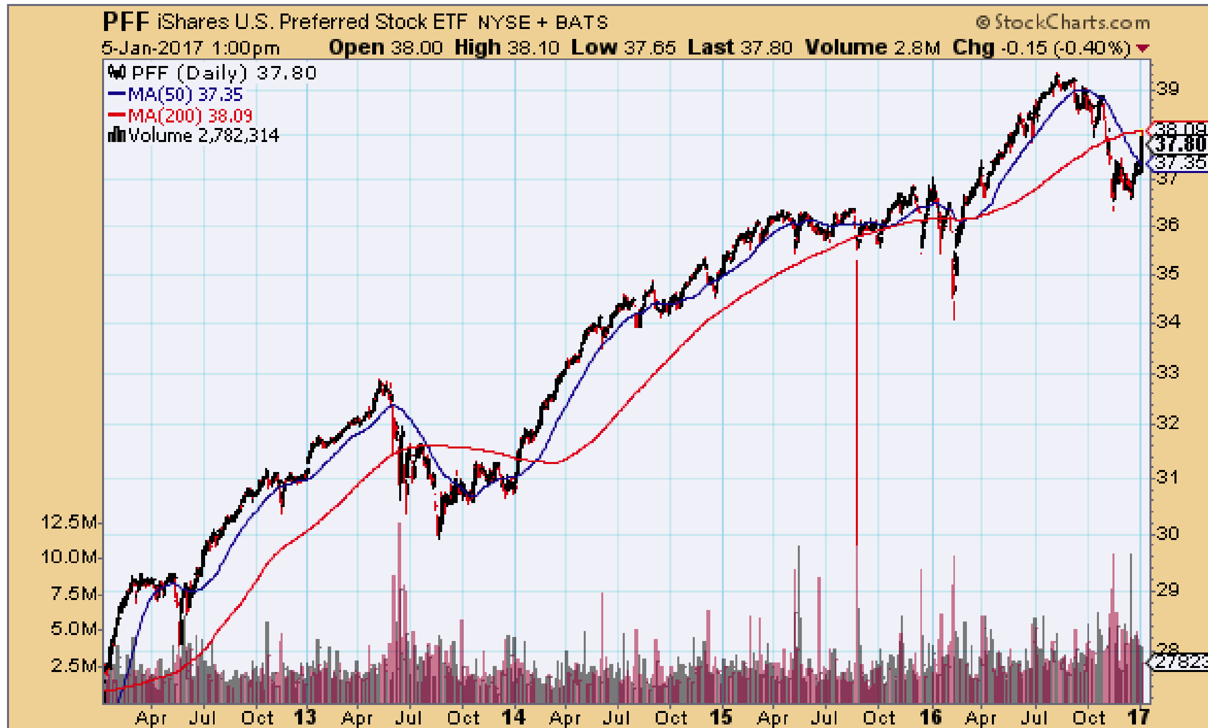


Source: StockCharts.com

What about the preferred shares?

A less risky way of acting defensive would be to buy the iShares preferred stock ETF (NYSEARCA:PFF).

The fund is predominantly allocated to banks (41.92%), diversified financials (19.33%), real estate (10.89%) and insurance (9.1%). Also, a large portion of the ETF's holdings is traded near par, implying no extraordinary risks for the medium-term holders here.



Source: StockCharts.com

Conclusion

Having no confidence in the current rally, I propose a defensive short-term strategy of:

- Avoiding trendy stocks, small caps and financials;
- Collecting the distributions of the preferred stock ETF;
- Watching long-term Treasuries for a short position entry;
- Keeping an eye on gold for a potential long position entry.

A rotation towards less risky assets is happening just as I am finishing the article, and even though it might prove to be a short-lived one, I am not ready to join the "Dow 20,000" camp just yet.

Disclosure: I/we have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

Additional disclosure: This is not an investment advice. I am not an investment advisor.

Comments (16)

Stevlg
Good article and thanks.

So then, what about TMV as example...

Your response appreciated.

S

06 Jan 2017, 12:24 AM

Anton Tyumin, Contributor
Author’s reply » Dear Stevlg,

TMV would be an effective (yet risky) way of playing the dynamics of long-term Treasuries once the Fed's direction is clear. Thus, in case the 20-year breakeven rate continues to edge higher through June (implying rising inflation expectations), it might make sense to allocate a small amount of capital to TMV at a later point. Nonetheless, a safer way would be to short TLT directly or via put options (the premiums on June+ options are too high at this point, so it makes sense to wait).

07 Jan 2017, 02:06 PM

CaliKing
Come on over and enjoy a correction of another type, or should I say in another direction over in the PM sector .... I agree that the mantra in the stock market ought to be "look out below" but the opposite can be said of PM's. We are experiencing the calm before the storm. Zero chance, let me repeat that, ZERO CHANCE that Bush and Obama were greeted early in their young administrations with epic events (911 and economic meltdown for Obama) but Trump who get this isn't even one of "their" boys will be spared a similar "event". My guess ...much worse than the previous 2 "welcome to the NWO" events ....and who better to steer the USA through BK en route to a cashless world gov money than Mr BK himself Trump? Any other remote viewers in the house? (I'm personal friends with Ed D) Don't put too much faith in your past work. A "reboot" happened a few years ago that "reset" our current "reality" .... so to speak .... they're on to us!

06 Jan 2017, 12:31 AM

smurf
Well, I agree with the author about PFF, but not preferreds in general. Why would I pay nearly 50 basis points in expenses for PFF when I can buy an investment grade PSA preferred well under issue price paying close to the same dividend.

I think selected individual preferreds are a reasonable place to park money right now while earning a better than average yield.

06 Jan 2017, 12:46 AM

Anton Tyumin, Contributor
Author’s reply » Dear smurf,

Good point. I have focused on PFF since ETF investing might be more convenient for the majority of the readers and due to the fact that discussion of individual preferreds would require a much more detailed comparison and argumentation.

06 Jan 2017, 10:48 AM

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rcray
Why are you recommending preferred stocks as a hedge when they have very long durations (in fact many preferred stocks are perpetual)?

06 Jan 2017, 12:50 AM

NYer1
Anton
I believe you err on a few fronts in this article.
WHile I do share your cautious stance re the equity markets, where we differ is out=r opinion regarding the long bond prospects going forward during 2017.

I do not see significant risks to the long bond valuation in the current environment and especially if your projection f equity weakness comes to pass.

A significant correction (or even better, a bear market) in the equity market will cause long term yields to go lower regardless of what happens on the Fed Funds front.
Furthermore, what has been the correlation between fed fund rising and long term yields historically?
At a time when inflation is quite low and the economy exhibits low to virtually no growth, what sectors do you see with enough pricing power to affect an inflationary spike that would cause justified spurt higher in long term rates.

And then you come up with this pair trade:
" Collecting the distributions of the preferred stock ETF;
Watching long-term Treasuries for a short position entry;"

What you are proposing is antithetical to any logical and data based thesis.
Preferred stocks are credit instruments with a long term duration profile - a risk off environment will:

(based on historical evidence)

1. Cause long term rates to decline, not rise
2. Hurt credit instruments

In that vain, preferred shares would under perform long term treasuries under your assumptions.

JMVHO

06 Jan 2017, 12:55 AM

Anton Tyumin, Contributor
Author's reply » Dear NYer1,

Thank you for commenting. I should have been more clear with the time horizon difference. I propose PFF as a defensive short-term holding for the short-term, while the discussion of long-term Treasuries is aimed to prepare the reader for potential shorting opportunities in the future. In other words, I propose PFF as a safer short-term play in comparison with IWM, SPY, etc. At the same time, I leave the TLT for later: "However, for as long as the majority of the market participants only expect the Fed to come up with another hike in June (a 48.3% futures-implied probability of a 0.25% hike), I would still argue that better shorting entries are likely to follow in the coming quarters."

06 Jan 2017, 10:45 AM

NYer1
Anton
Thanks for the clarification.
As such, using PFF with its relatively long average duration may be too risky for the yield it pays.
Have you considered some short duration fixed income closed end funds trading at nice discounts to NAV as a better less risky alternative?

06 Jan 2017, 05:14 PM

Long_Bio
I've temporarily parked a decent amount of funds in PFF. And in the meantime the PPS has increased $1.

07 Jan 2017, 12:32 PM

6761901

the author is clearly very young and somewhat clueless. Long bond yields did NOT rise during last rate hike cycle and they probably won't rise that much in this cycle. In a disinflationary world, this makes sense, as the FED hiking merely means that they are starting to choke whatever little growth there is. The more the FED hikes, the less likely inflation is to take off, thus long bonds become more valuable.

long EDV, TLT, selected IG long bonds

06 Jan 2017, 01:15 AM

Anton Tyumin, Contributor
Author’s reply » "In a disinflationary world, this makes sense, as the FED hiking merely means that they are starting to choke whatever little growth there is."

Yet nonetheless, the 56 percentage point increase increase (Jun-Dec) in 20-year inflation breakeven rate has been accompanied by a 102 percentage point increase in 20-year constant maturity rates. As the Fed wasn't able to achieve its 2% inflation target for years, I seriously doubt that it can keep inflation low once it starts increasing.

http://bit.ly/2iM7yW0
http://bit.ly/2iJyl7u

06 Jan 2017, 10:59 AM

I, Investor
The author is correct (or was) about preferred ETFs. PFF, PGX, PFXF, and PSF are all nicely up since hitting 2016 lows in early to mid-December. Whether that trend holds or not is difficult to say. With higher NAV and lower yields, catching the preferred bus now may be a bit tardy.

06 Jan 2017, 02:14 AM

Decider
Economic Report: Mortgage rates tumble, snapping 9-week rising streak
http://on.mktw.net/2iL...
Looks like the tide has turned. I would seriously consider funds such as DMO.

06 Jan 2017, 07:47 AM

Jack Reacher
Preferreds will get hammered when rates go up.

06 Jan 2017, 03:39 PM

Peter Palms

China which for decades has been earning trillions of federal reserve notes in payment for their exports , stopped buying treasuries more than five years ago and have since sold all all they had purchaded in the past, preferring instead to acquire corporations internationally that own natural resources that have intrinsic value.

06 Jan 2017, 05:35 PM