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Q&A-Fed to begin taper in Q1 2022; Bullish on reduced maturities, higher quality credit and tech: Richard Saperstein, Treasury Partners

The U.S. Federal Reserve could start tapering by the first quarter of 2022 and begin hiking interest rates in 2023, **Richard Saperstein, CIO at Treasury Partners,** told the Reuters Global Markets Forum on Thursday, Aug. 12, forecasting the 10-year U.S. Treasury yield to rise to around 1.75% by the end of 2021 and toward 2.5% in 2022.

Based on the "low level of coupon protection" in this environment, Saperstein said his firm was cutting average maturities of portfolios in some cases while moving into the less risky investment-grade corporate debt in others.

In equities, Treasury Partners is bullish on U.S. large cap technology stocks as they will benefit in the aftermath of COVID-19 pandemic and China's recent regulatory crackdown.

"Clampdown on China's great technology companies will result in reduced appetite of Western investors for these stocks and corresponding increased appetite for U.S. tech stocks," he said.

Following are edited excerpts from the conversation:

Q: What are the investment implications of China's tech/cross industry clampdown for fixed income and stocks?

A: Clampdown on China's great technology companies will result in reduced appetite of Western investors for these stocks and corresponding increased appetite for U.S. tech stocks. Primarily large cap FAAMG (Facebook, Apple, Amazon, Microsoft, Google). Also, the China clampdown will impact broader EM (emerging markets) indices and highlights the political risk of EM investing.

Q: Given the EM sell-off, are EM stocks and bonds (based MSCI benchmarks) are fairly valued or worth buying into?

A: We've had zero exposure to EM stocks and bonds since the GFC (global financial crisis). Likewise, our exposure to non-U.S. developed market equities is nominal post-GFC. Reason is that post-GFC, we believed the U.S., with one fiscal and monetary policy will navigate the post-GFC environment better than EZ (euro zone) or EM countries. The same rationale holds for the post-COVID-19 environment. Given this macro backdrop, we evaluate our exposures based on whether the risk of non-U.S. equities, where we assume currency risk, will outperform the S&P500. In addition, we believe COVID-19 has pulled forward the adoption of technology by five to 10 years. As a result, we want to be overweight tech-related equities. The U.S. presents the largest in number and market cap of tech related equities.

Q: In your opinion, how much risk has been priced in because of the spread of Delta variant in U.S. Treasuries (UST)?

A: I believe the single largest impact on UST rates is the Fed, which has been the largest buyer of UST, keeping rates low relative to inflation, GDP (gross domestic product) growth, etc. The second significant factor is the $16 trillion of negative yielding debt around the world.

Q: How are you positioning in fixed income portfolios in this low-rate climate?

A: Our base case is that the Fed begins to taper in Q1 2022, ends tapering (in) Q4 2022 and then potentially starts to increase Fed funds (rate) in 2023. Given this framework, we see the 10-year (Treasury yield) ending 2021 at 1.50%-1.75% and gradually rising to 2%-2.5% (by the) end of 2022. Given the low level of coupon protection against changes in rates, we're limiting all reinvestments to four years maximum. Best value is found in corporate financial issuers and callable municipal bonds.

Q: What are your preferences within fixed income i.e., investment grade (IG), high yield (HY), municipal bonds -- and the what's the "why" behind the same?

A: We're not adding HY as spreads are too tight. We're buying municipal kicker bonds, meaning these are 10-20-year bonds that are callable in one-to-four years. If they aren't called, they 'kick' to the coupon rate which range from 3%-5%. We expect these to be called, but are comfortable with the returns, if they aren't. We buy a wide range of credits including revenue systems, airport bonds, transportation facilities and toll roads. In the IG space, we're buying the large cap banks and select issuers in the BB and BBB credit ranges.

Q: What do you expect from Jackson Hole? Could there be a market sell-off induced by a changing Fed Policy?

A: I view this as a counter intuitive event. If Fed announces tapering, after initial possible shock, stock market resumes moving higher as tapering is an indication that the Fed is confident in the handoff from supportive monetary policy to a traditional growth trajectory.

Q: Do you believe high inflation will be transitory?

A: Our base case is that it's primarily being caused by supply chain logjams and labour shortages. We expect these to be sorted out over the next six months and gradually, the elevated inflation prints will start to decline. So that would put us into the transitory camp. However, inflation will 'level off' at a higher rate than we experienced pre-COVID-19.

Q: Given where yields are, should investors hold fixed income to trim portfolio risk or are there better forms of ballast?

A: This is the most common question facing investors. Our clients typically pursue a three-dimensional portfolio strategy with fixed income, equities -- market correlated -- and alternatives -- less market correlated. Portfolios are assembled based on the level of volatility and upside/downside capture a client is comfortable assuming. Over the last few decades, fixed income has provided a buffering effect in reducing volatility -- versus market related equities. In the current environment, with rates below 1%, fixed income will not be a buffer. Meaning as the economy improves and the Fed starts to pull the punch bowl away, bond prices can drop -- rates higher -- while equities go higher. As a result of this construct, clients must choose between two paths: to keep fixed income knowing that it will provide less than 1% returns, but the portfolio will maintain a stable value asset, or migrate into other asset classes which will have increased volatility and will not be a stable asset class.

Q: Where do you see them migrating to?

A: That's the million-dollar question. Our advice is not one size fits all. It depends on client wealth, need for capital, age, health, risk tolerance and a host of other factors. That being said, here are some general parameters: younger clients, less than 40 years, should increase equity exposure and reduce fixed income drag on returns. Clients 40-60 years old, still working and adding to their asset base, should also consider reducing fixed income and migrating into equities and potentially less market related investments. For clients 60+, the decision is very nuanced and comes down to willingness to hold equities through a potential downturn in the next decade. We welcome these thoughtful discussions with clients as it informs our adjustments to asset allocations.

Q: Any parting views for us?

A: This is a highly differentiated investment climate with the massive fiscal and monetary support, which I haven't witnessed in four decades of investing. As a result of this support, we're witnessing certain distortions in asset prices which at some point, will unwind when/if policy is normalized.

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