ALPHA SOURCES

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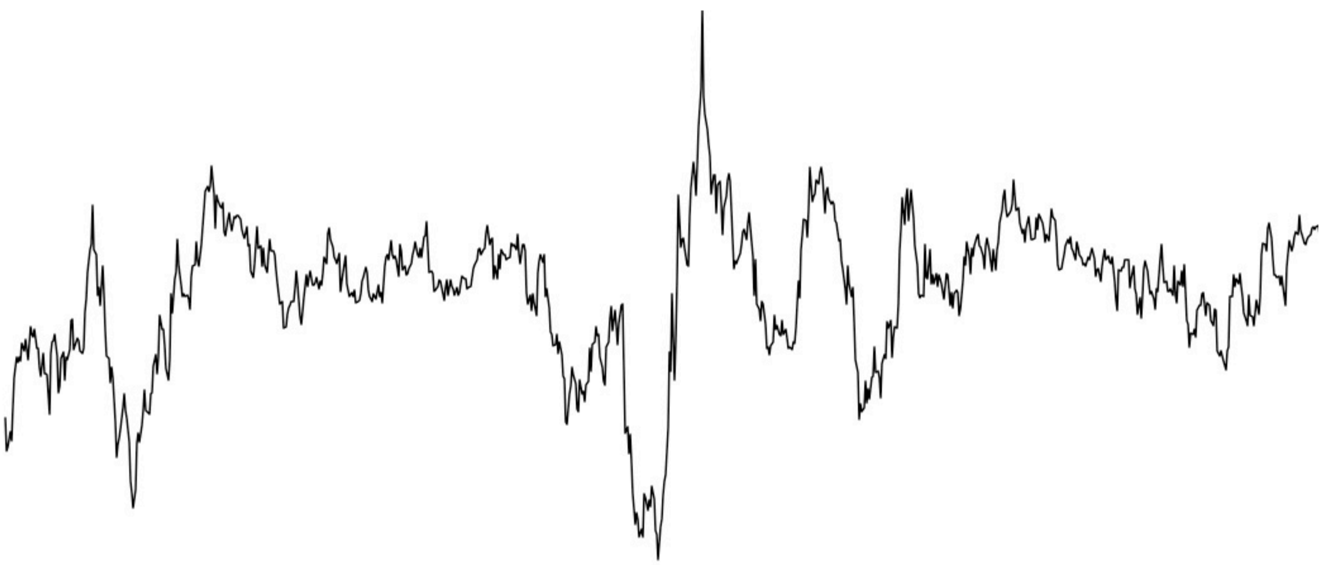

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The jury is still out, but I reckon that last week's price action provided a foundation for markets to finally get an answer to the question that's on everyone's mind. The sustained climb in equities, and precipitous decline in the dollar, are interesting in their own right, but am keeping my eyes on the US bond market. The long bonds sold off steadily through the week, a move that culminated with Friday's curveball of a NFP report—payrolls *rose* by 2.5M breezing past the consensus of a 7.5M fall—and a further leap in yields. All told, the US 10y rose by almost 30bp last week, to just under 0.9%, and with the front-end more-or-less locked, the 2s10s and 2s5s steepened to 70bp and 30bp, respectively, which is the widest since early 2018. A closer look at the chart won't really raise any eyebrows. Sure, the curve is steepening, but it's not like the move is unprecedented, and the curve is still overall quite flat. In the present context, however, last week's move is a clarion call to the Fed. Will they allow (long-end) bond yields to reflect the deluge of debt issuance, and associated economic rebound, or will they, as some have suggested, put the Treasury market on a "war footing" via a yield cap? **In other words, it's do or die for the decision on yield curve control.** Of course, that's not entirely true. The Fed has been waffling on this issue for ages, and there is no guarantee that they won't continue to do just that. That said, I have to say that last week's squeeze in bonds offers a very tasty and clear setup for this week's FOMC meeting. Will the Fed let long yields run or will they put a lid on them, either verbally, or via an outright YCC announcement?

I know that I have been harping about this question for ages, but there is a reason for that. *The US government bond market is the world's benchmark financial instrument, so if the men and women with the USD printing press decide on a yield cap—which is equivalent to price controls—it's fair to say that it would be a pretty big deal.* All other global assets would be profoundly affected by such a decision, as would the response of policymakers in the rest of the world, both fiscal and monetary.

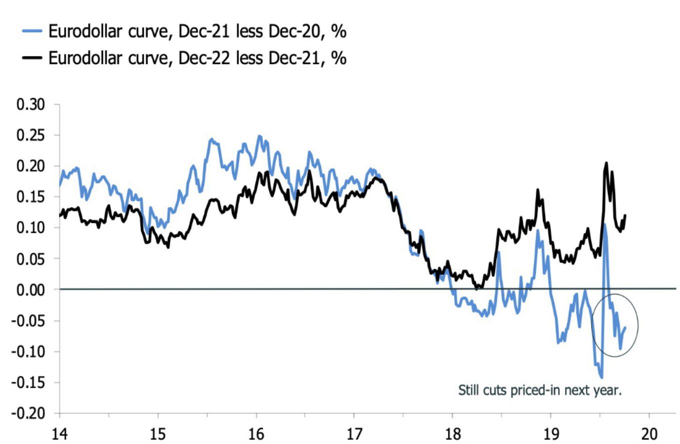
YCC is a tool that can take numerous forms, but just to be clear; in this case we're talking about a policy meant to signal that rates will be lower for longer, probably a lot longer, and possibly with and outright cap to the upside. Judging by comments from Fed officials, I suspect markets are eyeing two outcomes, more or less.

1. YCC lite - In this version, the Fed makes a transition to some a form of forward guidance along the lines of the ECB. It could be state or time contingent or a mix of the two. Combined with the central bank's own forecasts for unemployment and inflation, this would allow the Fed to solidify the signal that it has no intention of lifting the Fed funds rate for a long time, and in any case, not until both inflation and unemployment have been "normal" for some time. This wouldn't change anything on the front-end insofar as goes that it is already pricing-in just that. By contrast, I suspect many investors would see such a shift as an invitation to buy 5s10s and 2s10s steepeners—financed perhaps by a 2s5s flattener—especially as the reality of the widening budget deficit hits home. In other words, the key question with such a move is whether longer maturities will sell off if the Fed opts to "just" sit on the front-end.

2. Full-fat YCC - In this scenario the Fed acts more aggressively, announcing an outright yield cap, at a specific maturity. The 10y would be the obvious choice, and almost surely would be associated with a sharp 2s10s and 5s10s flattener, depending on what level the Fed opted for. As with the example above, the main question is whether maturities beyond the Fed's cap would sell off, creating "kinks" in the curve. I suspect they would, though a 10y cap would be an aggressive tool, holding down rates across in all fixed income asset classes, and across all maturities.

Whatever the Fed decides to do, if anything, I'll make two predictions. First, talk will be cheap. A lot of comparisons have been made with the BOJ's yield cap on the 10 JGB, which is arguably the greatest monetary policy trick ever pulled. After all, the BOJ has been buying less JGBs since the policy

fig. 01 / Is the Fed ok with this? - **fig. 02** / Would YCC flatten the 22-21 curve?



announced. In fairness, the BOJ's objectives are not the same as the Fed's would be—it wanted a steeper, not a flatter curve—but the comparison is interesting from a signaling perspective. **The radically different ownership structure and overall difference in volume and liquidity between USTs and JGBs mean that the Fed surely would have to back up YCC with action, at least to some extent.**

Secondly, it will be very interesting to see whether markets will try to find ways around any specific yield cap, creating "kinks" in the curve mentioned above. For example, if the 10y is targeted, will the 10s30s steepen etc. Obviously, a non-smooth curve ought to be smoothed by both supply and demand, but because YCC is uncharted waters, we can't be sure.

The only thing left is to discuss is whether the Fed will go down this path or not? I don't know, but that's precisely why the setup coming into this week's FOMC is so tasty. Fed officials have mused enough on YCC, and markets have speculated accordingly, that the Fed is on the spot this week.

Of course, even if no concrete action is announced this week, Mr. Powell could still try to talk yields down. I suspect, however, that this is a strategy with rapidly diminishing returns. In other words, we're getting close to the point at which the Fed either puts up, shuts up, or does something.

The economic rationale for YCC is simple enough. The government needs to spend a lot of money to carry the economy through the Covid-19 epidemic, and by capping rates, the Fed can help reduce the costs. Another way to put it is that a yield cap almost surely would be set at a level, generating a structurally negative *real* rate for the duration of the program.

More generally, I don't see why the Fed, or any other major central bank, should be so worried about a steepening yield curve, if it ever came to that. In an environment of endemically low short-term rates, and plenty of global savings—especially now thanks to the precautionary motive—non-official flows would eventually move out the curve to take advantage of the roll and carry, keeping a lid on yields.

It is also ironic that central banks, ostensibly desperate to generate an uptick in inflation expectations and nominal GDP growth, would raise a red flag over the very market signal suggesting that they're succeeding. That, however, opens the door for a fundamental question about what exactly the end-game for Team BRR/MMT is, a topic I dealt with extensively in my latest long-form essay. I will return to that theme in due course, but for now, the scene is set for the world's largest central bank to decide on a yield cap on the world's most important financial instrument; get ready.

fig. 03 / The disappearing yield in the US - **fig. 04** / A strong source of support for equities