ALPHA SOURCES

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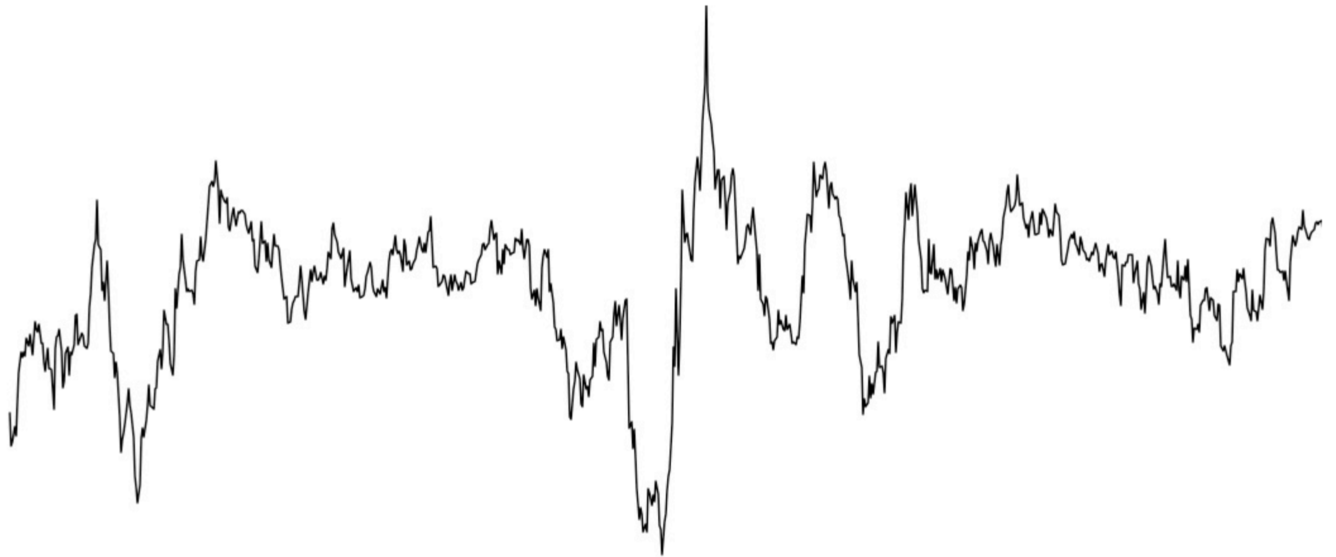

REMEMBER THE DEAL

I'll keep it short this week, mainly because I don't have much new to say. I continue to think that the tug-of-war between markets and monetary policymakers in fixed income markets remains the key spectacle to watch, even if I concede that we have been watching it for a while. There are economists and strategists who will tell you that policymakers are perfectly happy with steepening yield curves, and that they in fact welcome them. To believe this, however, requires that you forget the initial stages of the pandemic-policy response in which central bankers solemnly pledged to print as much money as needed—via QE—to keep rates pinned across all maturities in order to support the monumental fiscal efforts needed to prevent economic disaster. If you're telling me that this tacit agreement is now broken on the eve of the new US administration is about to shovel €1.9T into an almost fully vaccinated economy—that's just shy of 10% of GDP for those wondering—I have to concede that yields can, and likely will, move a lot higher. But is that really what you're telling me? It seems to me that observers have quietly pivoted towards the idea that central banks obviously accept, even want, higher bond yields to reflect the recovery. I am sorry, but that doesn't pass the smell test. While a steepening yield curve sows the seeds of its own destruction via an ever more attractive roll and carry, especially with fwd guidance on the front end, there is always a risk that markets end up questing the commitment to low policy rates.

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CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

As it turns out, this is exactly what is happening. When Mr. Powell says that the Fed is "not even thinking about thinking about raising rates", this is exactly what markets are now contemplating that the FOMC is, in fact, thinking about. The first chart below updates the trend I have been following the past few months in Eurodollar contracts. In words, the markets now expect short term rates to rise aggressively starting in 2023, with a hint of lift already next year. It will be interesting to see whether the Fed pushes back this week.

Other central banks are in a similar situation. The 3s5s in Australia recently steepened to a record—based on data going back to 2000—ostensibly because the RBA had to put its foot down on the three year, by raising the repo costs making it very expensive to short the front end, to defend its yield curve control/fwd guidance policy.

I am no expert in Aussie fixed income, but this is a simple setup. Either you buy the 5y cash bond in anticipation that it will in time become a 3y bond, that roll and carry again, or you keep chipping at the front end in anticipation that the RBA eventually gives up. Similarly in the US, there isn't really a middle ground. Either yields race higher or, as I discuss with traders here, the belly and EDZs are a screaming buy.

Interestingly, in my day job as Eurozone watcher this is a moot point. Yields have risen only marginally in the past few months, but that didn't prevent the ECB from announcing last week that it is not currently willing to entertain an increase in yields, of any maturity.

Higher long-term interest rates, coupled with looming inflation pressures in global energy and commodities, raises some tricky questions for equities. So far, an underlying rotation—which in itself is tied to rising yields—means that the S&P 500 is advancing to new highs, even as the Nasdaq is off 4% from its highs. **It's nice to see that value investors are finally having their day in the sun, and if their fortunes are now directly linked to the Fed's acceptance of higher bond yields, I'd even call it hilarious.**

The second chart below, however, shows why investors of all stripes, or at least those holding the market, ought to be worried about the rise in yields and oil prices. The faustian bargain between equity markets and policymakers is that the latter will preserve the bull market in the former, at least until such point at which this bargain becomes *politically* untenable. Assuming we are not there yet, everyone should be sure to remember the deal.

fig. 01 / Tell me again Mr. Powell what you are thinking - **fig. 02** / Do you feel lucky?