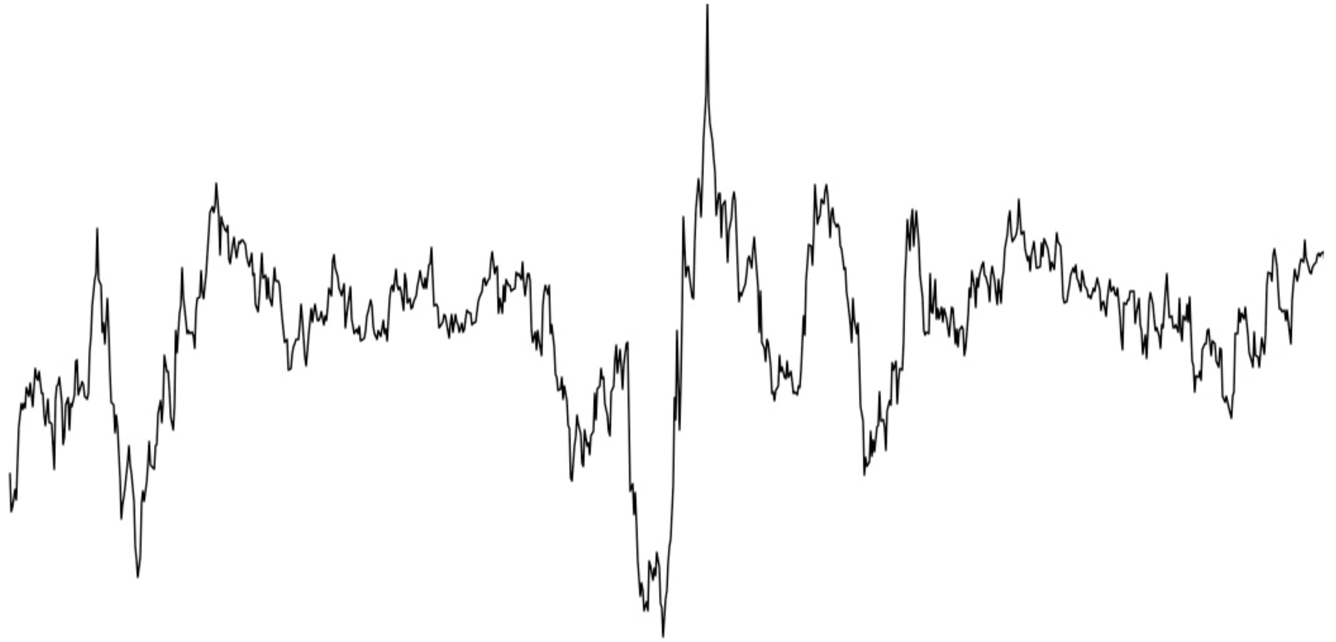
ALPHA SOURCES

MAY 12, 2020



DECISION TIME

Many investors understandably remain focused on the rally in equities, probably with a mix of satisfaction and astonishment. As interesting as the virus-defying rise in equities is, though, the real story this week has been in U.S. rates,

Let me explain. It started with analysts suddenly remembering that trying to shield the economy from the Covid-19 induced lockdowns is going to cost money. Markets' memory was stirred by the U.S. Treasury announcing that it is planning to place $3T worth of debt in Q2 alone, a cool 14% of GDP, and that's probably just the beginning. The initial response by many analysts was to extrapolate to a depreciation of the dollar. After all, that's an awful lot of currency that Uncle Sam will need to produce, assuming that is, that the Fed is going to stand up and be counted. As I argued in my day-job, that reaction was surprising to me. After all, it's not as if European governments won't have to dig deep either, and it's not clear to me that the race to throw money at Covid-19 favours a bet against the dollar. In any case, before we get to currencies, the incoming tsunami of U.S. debt issuance is also, obviously, important for fixed income, and in a world of uncertainty, I am happy to report that the movie currently on offer is one that we have seen before.

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In preview, the shift in the Fed's reaction function following the Q4-18 swoon in markets—effectively transforming FOMC policy into a lagged function of market expectations—is about to be put to the test, again. The Federales are being cornered on two issues. **Firstly**, while several Fed officials have commented that negative interest rates would be inappropriate in the U.S., that is exactly what the OIS market is now pricing, *for June*, with the 2y also descending to new lows.

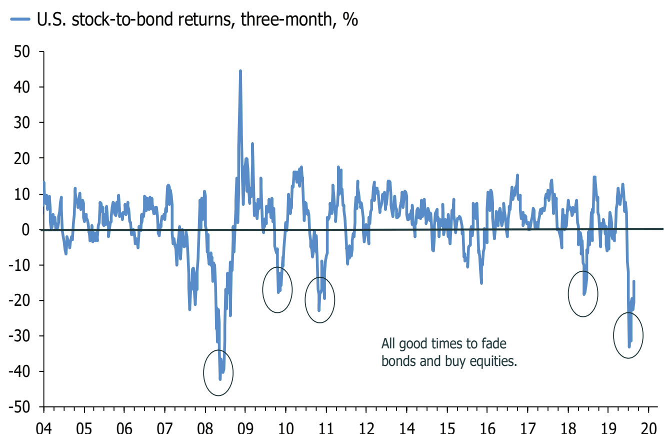
Based on past experience, the next step is a foregone conclusion. Markets will keep squeezing, and the FOMC will fold like a cheap suit. I concede that pulling the Fed Funds *below* zero isn't as easy as hitting the lower bound in the first place. That said, if the ground was ever ripe for markets to corner the FOMC on precisely this, the current environment seems to be it. *If* the Fed is compelled to take short-term interest rates below zero, I concede that it would challenge my scepticism about a sustained sell-off in the dollar, but I assume the ROW would respond in kind.

Secondly, the incoming wave of debt issuance will call out the Fed on whether to implement some form of yield curve control, either implicitly or explicitly. The setup is simple. The Fed is going to keep the front-end in a vice, but it has a decision to make on the long end. **It can let the costs of Covid-19 be reflected in the long bond—via a bear steepener—or it can reintroduce a form of Operation Twist, capping yields.**

As I have argued on these pages, whatever the Fed chooses will have profound consequences for other asset markets, in particular the almost mythical outperformance of growth over value in equities. Capping long-term bond yields in the U.S. would require the Fed to do more heavy lifting than in Japan, where the BOJ has the luxury of announcing it—and doing nothing—by virtue of the distinct ownership structure of JGBs. The FOMC already has a done a lot, and it is committed to do more of the same, but when it comes to rates, specific questions loom, and the Fed will have to decide on them soon.

fig. 01 / Markets still price cuts, but negative?

fig. 02 / Still time to fade bonds and buy Spoos



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