The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

11/3/2024

In last week's DSR, we provided a set of scenarios for the week just ended and the week ahead. We continue to believe that the coming week will be consequential. However, given global bond market movements last week, we think the risks are high that the consequences of next week's FOMC will be the Fed losing the long-end of the bond market. We are neutral on bonds at the current prices but, frankly, believe the bond market is warning the Fed that unless it reacts immediately to address bond market concerns the risks are great. It is rare for us to sound alarms, and we are not inclined to call wolf. However, too many obvious market movements are happening all at once for us not to take heed. We hope the Fed sees what has been unfolding clearly.

What does losing the long-end of the bond market look like?

To achieve the desired economic soft landing - near full employment and inflation near the 2% target, long-term interest rates must remain stable and neutral. What will certainly cause a hard landing is a restrictive long-term interest rate that discourages borrowing and encourages savings. A substantially higher long-term interest rate would also likely reduced equity P/E multiples significantly while discouraging real consumption. Wealth would suffer, as would financing costs for homes, gpu's, and most other real economy investments. In past economic hard landings, credit failures created the tightening. In this economy, with banks quite healthy and most corporate and household balance sheets flush, a credit crisis is very unlikely to happen first. For years now, term premiums have been benign, inflation expectations anchored, and the yield curve inverted, all of which have supported a higher for longer economy with tight labor, high real GDP versus trend, and inflation that remains sticky. Conditions have been easy despite the focus on short term real fed funds rates. Losing the long-end of the bond market would be the tightening that causes the hard landing. The Fed cannot let that happen to achieve its goals. The inflection point seems to us to be in prospect, if not at yet at hand.

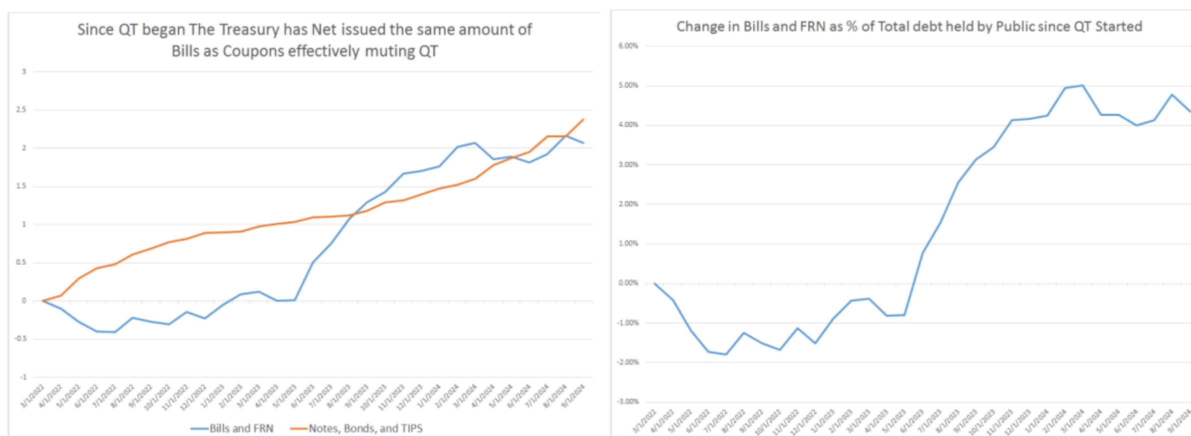
Losing the long-term bond market means 10-year bond yields of over 5.5%, 30-year bond yields over 6%, term premiums over 100bp, de-anchored market-based inflation expectations, and a collapse of equity multiples to 16. This is not a prediction. This is a potential consequence of the policy error made by both the Fed and Treasury if not dealt with rapidly.

Note this is entirely a financial markets phenomenon that almost certainly will not be felt by Main Street rapidly. Employment remains strong and inflation has fallen a lot - the soft landing is manifest in the data, but policymakers must remain highly alert. Will they? This is not clear, but the risks are blindingly obvious.

The Policy Error

If you have read any DSR over the past three years, you know that we do not care much about the short rate. While the bond selloff tempts most to name the 50bp cut in September as the policy error, we could not care less. No cuts, 25bp cuts or 50bp cuts don't matter in the slightest given the original sin policy error. The post-Covid economy is simply not sensitive to the short rate. Our view of the post-Covid economy has been and remains that long-term interest rates and the term premium that links them to expected return versus cash drives an economy where corporate and private sector balance sheets are insensitive to changes in short-term interest rates and highly sensitive to long-term asset prices.

The policymakers' original sin has been to use runoff to execute quantitative tightening. That sin took the most important monetary control out of the hands of the Fed and gave it to Treasury. Whether intended or not, Treasury muted the impact of QT versus the alternative of the Fed making outright assets sales. Regardless of the reason, extensive bills issuance relative to coupons muted QT.

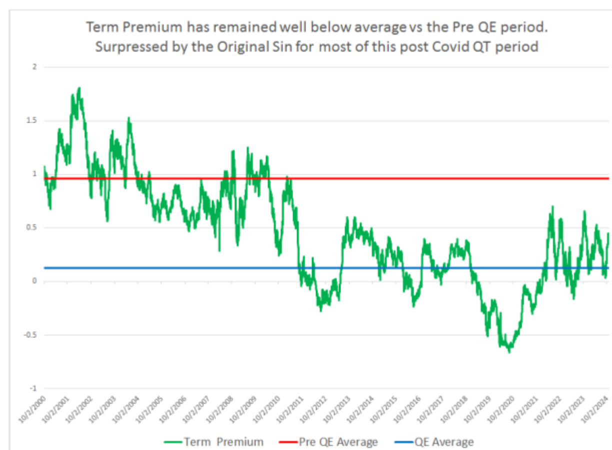


So what?

Good question. Things look pretty good. Inflation is nearing target, growth is strong, and employment seems full. By all appearances, a soft landing is incoming. Mission accomplished. Why are we saying the sky might fall? That is simple: It doesn't have to fall but choices made over the next few months may turn this soft landing into something far more difficult to manage. We think the bond market has been artificially kept aloft in price and suppressed in yield. That suppression has expanded earnings multiples. Strong equities and bonds have kept labor tight and supported consumption and investment. By luck or action, policymakers have created a soft landing on an asset bubble. To avoid a hard landing, the asset bubble needs to be kept pumped. The bond market has begun to leak. The Fed can perhaps keep the asset bubble aloft, but they need to act.

A true soft landing can be achieved.

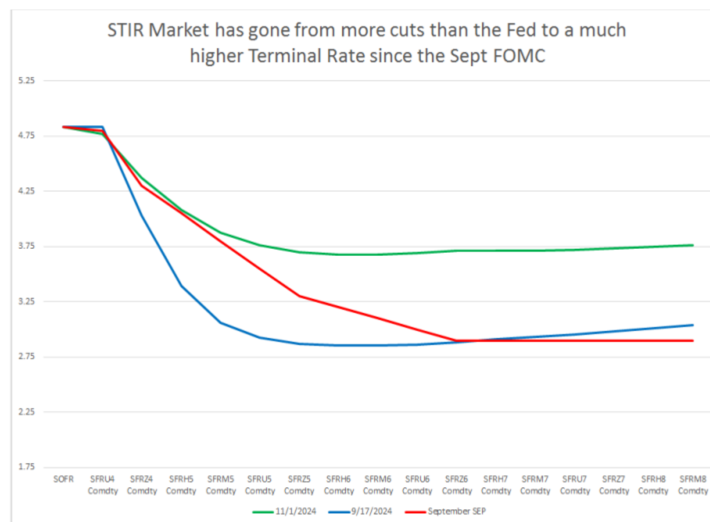
The current asset market is not normal.



Scroll up to page 1 and reread the last paragraph. It describes some major moves in asset markets:125 bp higher 10Y yields, 150bp higher 30Y yields, 60bp higher term premiums and a 27% drop in SPX forward P/E. Sounds dramatic! Again, this is not a prediction. But now step back and consider what a soft landing in financial markets looks like. Above we show that a non-QE term premium is around 100bp. A return to a normal curve with Fed Funds at 4.5% would generate these major moves in 10Y and 30Y yields markets fear. Equity multiples at 16x are "Normal." What is not normal are asset markets today:

We maintain that a soft landing in the real economy depends on a soft landing in financial markets. A soft landing for asset markets is one in which an adequate return is available for private sector investors relative to risk. An adequate return for risk is consistent with a term premium for long term bonds of 1%. Translating that term premium into equity indices is always tricky as it depends heavily on earnings expectations and changes in composition, but 22 P/E today has downside if bond term premiums continue to expand. Investment portfolios have generated fantastic returns during the period when bond markets were highly accommodative to both economic conditions and risky asset pricing. However, those returns

depended on both economic outcomes that looked like a soft landing and, more importantly, an expectation of future easy policymaker projections. We noticed the pivot toward concern about the labor market this summer by the Fed. Markets did too:



Concern about the labor market may or may not be valid. The GDI revision, the NFP for September, and the PCE inflation data have perhaps been root causes of the change in market pricing of the Fed path toward more hawkish. However, the notable change has not been for the near-term rate cut path. Rather, it has been the complete rejection of the idea of a sub 3% "neutral or longer run" interest rate.

What signs are suggesting a possibility that the Fed loses the bond market?

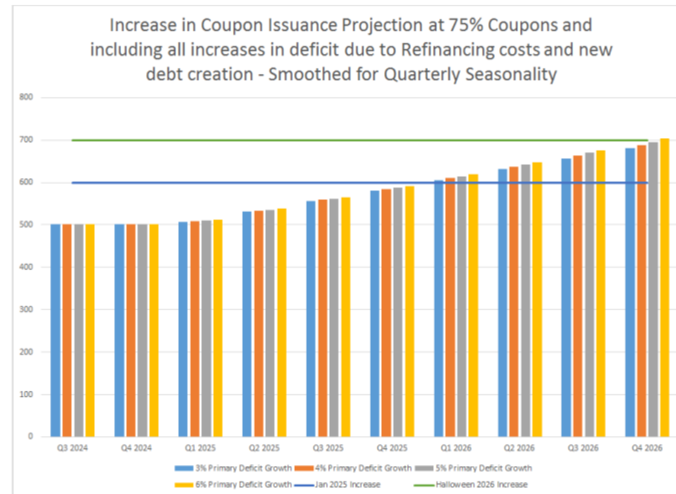
Economic data will continue to fluctuate with a bias to above-trend growth and sticky inflation if the bond market does not tighten conditions rapidly. In fact, it is unlikely that major shifts in the economy will happen simply because of short-term major shifts in asset prices, albeit the election creates some uncertainty regarding the real economy. We consider the inflection point as being primarily a financial market phenomenon that will be felt, with a lag, by the real economy. The signs of a potential major move in the bond market are:

- Supply continues to be large and inevitably increasing.
- Balance sheet capacity to own cash Treasuries is limited and expensive.
- Bank Term Funding Program ("BTFP") loan payoffs create demand for private sector financing or create actual supply if banks actually sell bonds, although this is unlikely as most are HTM.
- RRP is falling lately as the BTFP loan payoff creates demand for private sector repo and may reach zero by 1Q25 versus our estimate of1Q25.
- Deficits are unlikely to decline except potentially in a Blue Split and then not by much.
- Asian currencies are once again weakening and official sector demand for Treasuries is dropping.

- The current modestly positive slope in the yield curve is yet to create levered domestic demand.

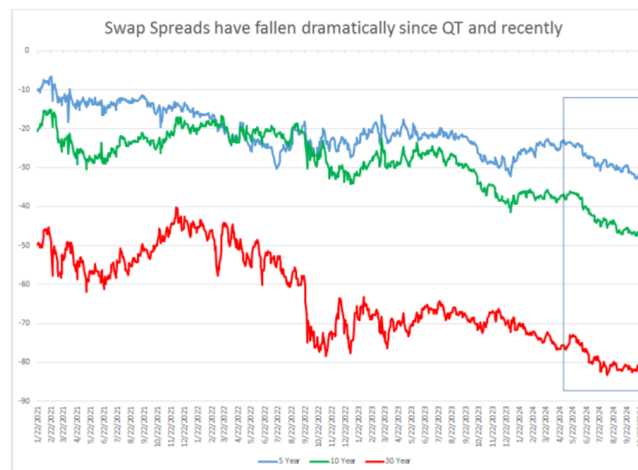
QRA

Last week, the Quarterly Refunding Announcement met expectations, with no increase in coupons and no change in language about future coupon increase. This was not a market-moving catalyst, but presage the inevitable drip drip drip of increased supply. Did the market wake up to that fact?

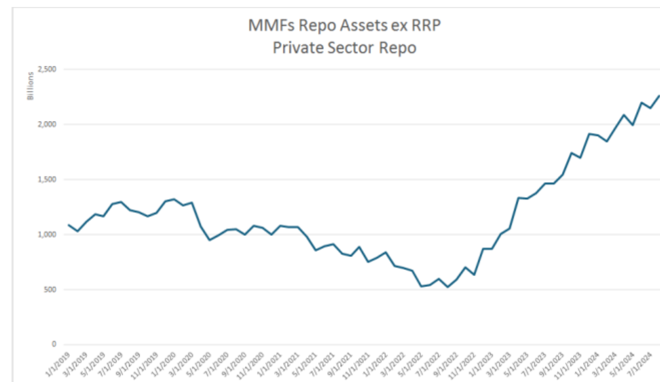


Swap Spreads

The level of swap spread took another leg down. This is the most direct indicator, when triangulated with repo levels, about what is going on in the cash bond market. Demand remains for duration risk from insurance companies, pension funds, and other long-only investors who want leverage. On the other hand, providers of that levered duration long must hedge their exposure with long cash Treasury positions that are financed in the repo market. Last week, swap spreads made new lows. Cash Treasuries have very little support:



Triangulating the imbalance in demand for cash Treasuries versus leveraged synthetic demand for cash Treasuries, we see that the private sector repo market has provided close to $2TN of additional leverage for private sector long cash bond holders since QT started, which is consistent with the falling swap spreads shown above.



Another demand for balance sheet funding has come from repayments of BTFP loans provided to troubled banks during the SVB crisis. Over the past 6 months, $100BN has been repaid, including over $50BN in the last two months. Those repayments were funded either by troubled banks financing in the private sector or by outright sales into the private sector of those assets financed in the program (though that is unlikely given that most funding was against HTM assets.). Regardless, the private sector repo market is seeing increased supply.

As supply builds in the private sector repo market, the Fed ON RRP shrinks. While QT runoff was tapered, the RRP flatlined in its descent. The BTFP has $57BN more to repaid through March 10, 2025, so, along with the QT runoff, the RRP may tap out in 1Q25.

Geopolitics, Stimulus in China and Japan, The Election, and carry/value

A volatile geopolitical environment, stimulative dovish actions in Asia, an election where most outcomes point to a wider deficit, and poor valuation on both term premium and carry suggest limited demand for bonds from the foreign official sector, global banks, and hedge fund investors.

Policy Expectations

Market pricing suggests close to a 100% chance of the Fed cutting interest rates next week. In addition, market analysts are looking at the decline in the RRP as a sign that QT will end soon and perhaps be announced at the next FOMC meeting. Chair Powell did a good job pivoting toward patience after the surprise revision to the GDI figure removed downside risk to his outlook, but he continues to be resolutely dovish (except for Jackson Hole 2022) and markets likely expect him to continue the dovish press conferences. If those things all come true, the bond market will get destroyed and do the work that the Fed to date refuses to do. A hard landing for the financial markets will be followed by a hard landing for the real economy.

How to avoid losing the bond market

The best way to ensure a soft landing of the real economy is to have a soft landing for the financial markets. We believe that the market is at an infection point. The market will either have a hard landing and drag the economy down with it or, if supported by thoughtful policy action, it will land back to normal valuations and curve shape slowly over time and avoid crashing the economy. The trend toward normal inflation, growth, asset valuations, and curve shape can absorb the large issuance, the banking system will find buyers for cash bonds at normal term premiums and carry. This warning is not a doom story. Policymakers can do what they are supposed to do dampen the forces at play to avoid uncontrolled disruptive market moves.

We think the best way for the Fed to achieve its goals is to slow the bond selloff by humbly pivoting back toward hawkishness. Specifically:

- Pause in November or give clear guidance that December is off the table.
- Reiterate the Fed’s commitment to reducing the balance sheet regardless of the RRP level.
- Give clear guidance that the terminal rate is probably much higher than previously thought.
- Give clear guidance that, although the Fed prefers to avoid job losses, it is willing to accept some losses to be sure that inflation is well and truly back to target.
- Indicate that part of the 5-year review will focus on bringing the balance sheet to a more sustainable composition consistent with the Fed’s long-run goals.

- We strongly suggest also changing reinvestment of maturities above the QT cap in only 5Y and under notes and bills.

All these suggestions are hawkish. There is little downside to hawkishness. The market has already moved from a terminal rate of 2.8% reached in 12 months to a 3.75% terminal rate in 18 months. However, by being clearly hawkish, the Fed will, for the time being, make the long-end of the yield curve very happy. A happy long-end prevents a rapid and uncontrolled de-risking and its negative consequence for the economy. Slow and steady back to normal in both the economy and markets is the soft landing for which we all hope.