The Major bond letter

#31. See-saw

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Fixed Income - Rates

Global

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When a central bank pushes the policy rate above its own measure of equilibrium, or neutrality, it most likely increases the probability of the rate eventually returning back there. We think this makes sense.

The longer-run equilibrium is an interest rate in the future, generally accepted as five years or so from now. This is the level at which the economy is neither too hot, nor too cold. Full employment is achieved and inflation is close to its targeted level.

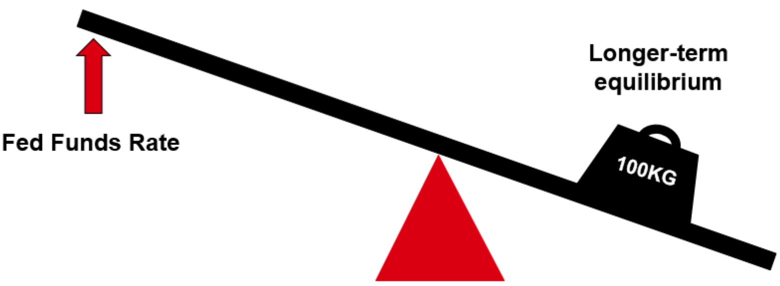
Our diagram below implies there is only so far you can lift rates before having to pause and eventually reverse. Granted, policymakers may want the focus to be purely on the near-term policy rate (on the left), and economists will have different opinions on what the equilibrium is (on the right). It's anyway difficult to question the physics. When one side of the see-saw is pushed up the other is pulled down.

We think this framework is a good way to address the higher-for-longer challenge to the lower-for-longer regime that prevailed for so long. At the centre of the debate is the question of whether the real rate of interest – what you get after adjusting nominal yields for inflation – will return to its pre-pandemic levels, or whether it will need to stay higher for longer and signal a shift to a new regime.

First, to change from one regime to another requires a large upward move in the equilibrium real rate, one that can be sustained by positive feedback loops. Here we are referring to the right side of the chart, the longer-run neutral rate, and yes, we showed our bias by putting a huge weight there. This is determined by the longer-term determinants of this rate, and the current focus is on excessive debt in the banking system.

When money is borrowed, if it is to have an upward impact on the real rate, it has to be productive and feed into potential GDP growth. But in recent times more debt is begetting more debt. It is increasingly looking like a large part of the solution to the current stress in banking systems will be "extend and pretend". Higher policy rates have again exposed leverage in the system. This happened last year when the UK government proposed a large fiscal loosening: markets didn't like it.

Higher now, lower later



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Second, all the focus is on the next move in the policy rate – the one on the left side of the chart – because until now, the challenge of the day has been inflation that is "too high for too long" (ECB President Lagarde, 16 March 2023). Central banks know that by pushing the policy rate higher, they will cool inflation but also run the risk of a recession.

Overdue a deleverage, the global economy is acutely sensitive to higher rates. If total debt is multiples of GDP, then the impact of each rate hike is heightened. The response to the pandemic, energy crisis and other challenges have only added to the global debt stock, across both public and private sectors. It's called a debt overhang because a lot of it is unproductive and still has to be paid back. Hike too much and you break something.

Three, moving at pace, policy rate hikes aggressively pushed the left side of the see-saw up. If central banks were caught out by the inflation surge, so were bond investors, with the *worst year on record*. It was this time last year that the Fed's first rate hike was delivered. Only two years ago, when no hikes were in sight, the yield on the two year US Treasury yield was just 0.15%. It was above 5.0% recently until concerns about stress in the banking system took it below 4.0% on several occasions last week.

Monetary policy works with a lag, and let's not forget the ongoing quantitative tightening (QT) which means central banks have been withdrawing liquidity. If new measures are needed to support the banking system, these will entail moving central bank balance sheets in the opposite direction of the QT. There is hence an argument for a pause here too.

Fourth, the surge in volatility is arguably a backlash from all those years of suppressing it. When markets are volatile, it becomes difficult to know the true price of anything because it's moving up and down so fast. Higher volatility means rising risk premiums as investors ask for compensation in the form of wider spreads.

We would argue that the higher risk premium on longer bonds has been building up for some time. Since inflation peaked last October, the longer-run equilibrium real rate implied by the inflation-linked market has been in a range of 50-100bp above the Fed's measure of 50bp (2.50% adjusted for the inflation target). To those that argue for a regime shift, this would suggest it is already in the price. For those that think there is no such change in regime, the risk premium should dissolve slowly over time and the market-implied yield fall back to where it came from.

So given all of this, policy-makers have their work cut out. They have been focused on inflation that's too high and are now challenged by the health of the banking system. It's all very well separating monetary policy from financial stability, but the bond market doesn't really care. It knows that the two are inextricably linked.

What a week in the bond market that was. On both sides of the Atlantic, investors were almost solely focused on the size of the next rate hike. Now it's all about bank balance sheets and where the next surprise might come from. When liquid benchmark yields can move more than 100bp in a few days, the consensus view is clearly being challenged.

Whatever one's view, however, it's difficult to deny there's a lot of leverage in the system given current events. It remains highly improbable that the weight will suddenly be taken off of the right side of the seesaw; we may have reached the point where the left side can't go up anymore.

Previous editions of 'The Major bond letter'

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