

The Major bond letter

#19. Warp speed

Free to View
Fixed Income - Rates

Global

Star Trek's Enterprise¹ was propelled with a warp drive which could generate an extraordinary surge of energy, enabling travel faster than the speed of light. But this impressive technology could also be unstable, so an unintended consequence was that the crew could end-up in some strange places.

Inflation has been rocketing higher. Not to be outdone with the superlatives, expectations in the bond market have increased at warp speed. James Bullard, a leading hawkish voice in the Federal Reserve, now speaks of the possibility of a 75bp rate hike at a single meeting (19 April 2022). This has really upped the ante. The Fed seems to be in a hurry but how fast can rates be lifted to the so-called neutral rate?

Futures markets have already priced in a succession of 50bp rate hikes, recognising an accelerated pace from the more 'normal' 25bp increments. As much as 250bp in total by year end is in stark contrast to one year ago when there was not a sniff of rate hike expectations. But how do we know when enough is priced in, and when peak hawkishness has been reached?

Inflation is so high that the real policy rate – after adjusting for inflation – is deeply negative and setting new records. US policy rates were lifted to 0.25-0.50% on 16 March but, in real yield terms, this first hike merely represented a drop in the ocean, as inflation recently printed above 8%.

The surge in inflation would not be a problem if it was entirely generated by supply constraints, related to food and energy, but central banks cannot just sit back and wait for it to normalise. That's why there has been a surge in the forward real rate to levels above the Fed's measure of longer-run neutral (see Figure 1). The chart shows the three-month real rate, five years forward, which has risen about 200bp in the last six months, to a level not far from the last cycle peak when the Fed was guiding long-run real rates of about 100bp.

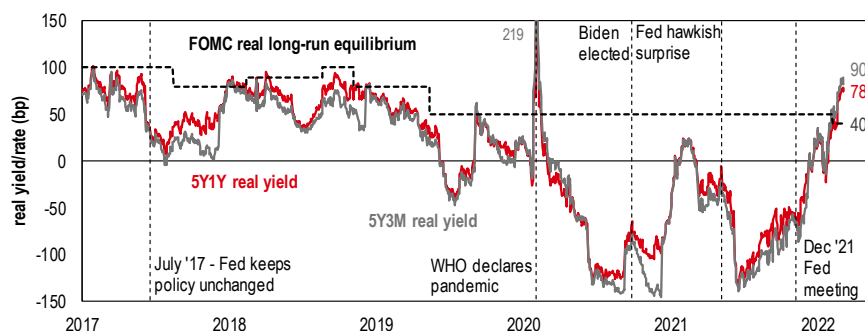


Steven Major, CFA

Global Head of Fixed Income Research

The Hongkong and Shanghai Banking Corporation Limited

Figure 1. Real forward yields above longer-run equilibrium



Source: HSBC, Bloomberg. Note: Five year forward TIPS real yields

This is a Free to View version of a report by the same title published on 22-Apr-22. Please contact your HSBC representative or email AskResearch@hsbc.com for more information.

¹ Star Trek (TV Series 1966-1969)

Disclosures & Disclaimer

This report must be read with the disclosures and the analyst certifications in the Disclosure appendix, and with the Disclaimer, which forms part of it.

Issuer of report: The Hongkong and Shanghai Banking Corporation Limited

View HSBC Global Research at:
<https://www.research.hsbc.com>

Usually when rates are rising we can observe that inversions tend to come much later in the cycle, highlighting that the Fed really needs to hurry up with those rate hikes. Or perhaps this is just totally different and, as in Trek-speak, the Fed needs to “boldly go...”.

Meanwhile the classic bear-flattening of the yield curve reflects central banks recognising the greater risk of expectations getting out of control. Two weeks after the first hike the 2-10yr segment of the Treasury yield curve inverted, signalling the market’s concern that rate hikes can only go so far.

The problem is that none of us knows exactly what neutral is, including the central banks who have anyway been powerless to reverse the falling trend in real rates over the last three decades. Hiking rates fast will just be the latest test of the lower-for-longer hypothesis. In our view the key determinants – including ageing populations, debt overhangs, disruptive technology, and wealth inequality – are unlikely to have suddenly gone into reverse.

Based on the FOMC’s March dot plot of rate projections, the median for rates is close to 3.0% for next year before later returning to the longer-run equilibrium of 2.40%. This means that under the assumption that the Fed will meet its longer-run 2.0% inflation objective, the longer-run equilibrium real rate is around 40bp. Markets are similarly prepared to accept that rates have to go beyond the longer-run equilibrium in the near-term, with forward real rates close to the levels reached in the last cycle (see Figure 1).

We recognise, however, that references to the last cycle can only go so far, given that this tightening comes two years after the start of a global pandemic and with a war in Ukraine. But it does look like a lot is priced in, before the bulk of the anticipated rate hikes have been delivered. Furthermore, this is without considering a tightening of financial conditions.

In normalising monetary policy, the Fed sees quantitative tightening (QT) having an impact on financial conditions and working in tandem with its rate tools. Equity markets and credit spreads are the important components of financial conditions indices which presumably means policy needs to have an impact on these soon. So far, markets have mainly reflected the tightening through rate expectations.

We are not identifying anything new here. If the Fed wants to have an impact on inflation expectations it has to show willingness to deliver at least the rate hikes priced into the forwards. But if they go too quickly they risk tightening financial conditions by too much and could provoke a hard landing. This is where the idea that the Fed hikes until “something breaks” comes from.

The ultimate question we would like to ask the Fed: what’s the right speed at which to hike rates to maximise the probability of avoiding a recession? The answer would probably come with a lot of conditionality, that it depends on a number of assumptions regarding inflation, employment and the global economy. Captain Kirk asked Mr Spock: “You suspect some danger?” Mr Spock replied: “Insufficient facts always invites danger, Captain”.

Previous editions of ‘The Major bond letter’

- | | |
|--|--|
| #1. <u>Eurozone common issuance</u> | #10. <u>Taper and the Hole</u> |
| #2. <u>How to spice it up in a dull market</u> | #11. <u>Every basis point counts</u> |
| #3. <u>New year, old narrative</u> | #12. <u>Push back</u> |
| #4. <u>Beneath the surface</u> | #13. <u>Game of chicken</u> |
| #5. <u>The bond market sell-off</u> | #14. <u>Across the pond</u> |
| #6. <u>Treasuries and trees</u> | #15. <u>The most insightful question</u> |
| #7. <u>Inflation rationality</u> | #16. <u>QT teaser</u> |
| #8. <u>Lucky number</u> | #17. <u>Hikes that won’t stick</u> |
| #9. <u>Stuck in the middle</u> | #18. <u>China-US divergence</u> |

Disclaimer

The following analyst(s), who is(are) primarily responsible for this document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained in this research report: Steven Major, CFA

This document has been issued by The Hongkong and Shanghai Banking Corporation Limited, which has based this document on information obtained from sources it believes to be reliable but which it has not independently verified. Neither The Hongkong and Shanghai Banking Corporation Limited nor any member of its group companies ("HSBC") make any guarantee, representation or warranty nor accept any responsibility or liability as to the accuracy or completeness of this document and is not responsible for errors of transmission of factual or analytical data, nor is HSBC liable for damages arising out of any person's reliance on this information. The information and opinions contained within the report are based upon publicly available information at the time of publication, represent the present judgment of HSBC and are subject to change without notice.

This document is not and should not be construed as an offer to sell or solicitation of an offer to purchase or subscribe for any investment or other investment products mentioned in it and/or to participate in any trading strategy. It does not constitute a prospectus or other offering document. Information in this document is general and should not be construed as personal advice, given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on it, consider the appropriateness of the information, having regard to their objectives, financial situation and needs. If necessary, seek professional investment and tax advice.

The decision and responsibility on whether or not to purchase, subscribe or sell (as applicable) must be taken by the investor. In no event will any member of the HSBC group be liable to the recipient for any direct or indirect or any other damages of any kind arising from or in connection with reliance on any information and materials herein.

Past performance is not necessarily a guide to future performance. The value of any investment or income may go down as well as up and you may not get back the full amount invested. Where an investment is denominated in a currency other than the local currency of the recipient of the research report, changes in the exchange rates may have an adverse effect on the value, price or income of that investment. In case of investments for which there is no recognised market it may be difficult for investors to sell their investments or to obtain reliable information about its value or the extent of the risk to which it is exposed. Some of the statements contained in this document may be considered forward looking statements which provide current expectations or forecasts of future events. Such forward looking statements are not guarantees of future performance or events and involve risks and uncertainties. Actual results may differ materially from those described in such forward-looking statements as a result of various factors.

This document is for information purposes only and may not be redistributed or passed on, directly or indirectly, to any other person, in whole or in part, for any purpose. The distribution of this document in other jurisdictions may be restricted by law, and persons into whose possession this document comes should inform themselves about, and observe, any such restrictions. By accepting this report, you agree to be bound by the foregoing instructions. If this report is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate. The document is intended to be distributed in its entirety. Unless governing law permits otherwise, you must contact a HSBC Group member in your home jurisdiction if you wish to use HSBC Group services in effecting a transaction in any investment mentioned in this document.

Certain investment products mentioned in this document may not be eligible for sale in some states or countries, and they may not be suitable for all types of investors. Investors should consult with their HSBC representative regarding the suitability of the investment products mentioned in this document.

HSBC and/or its officers, directors and employees may have positions in any securities in companies mentioned in this document. HSBC may act as market maker or may have assumed an underwriting commitment in the securities of companies discussed in this document (or in related investments), may sell or buy securities and may also perform or seek to perform investment banking

or underwriting services for or relating to those companies and may also be represented on the supervisory board or any other committee of those companies.

HSBC will from time to time sell to and buy from customers the securities/instruments (including derivatives) of companies covered in HSBC Research on a principal or agency basis.

From time to time research analysts conduct site visits of covered issuers. HSBC policies prohibit research analysts from accepting payment or reimbursement for travel expenses from the issuer for such visits.

Analysts, economists, and strategists are paid in part by reference to the profitability of HSBC which includes investment banking, sales & trading, and principal trading revenues.

Whether, or in what time frame, an update of this analysis will be published is not determined in advance.

For disclosures in respect of any company mentioned in this report, please see the most recently published report on that company available at www.hsbcnet.com/research.

The Hongkong and Shanghai Banking Corporation Limited is regulated by the Hong Kong Monetary Authority. If it is received by a customer of an affiliate of HSBC, its provision to the recipient is subject to the terms of business in place between the recipient and such affiliate.

Additional disclosures

- 1 This report is dated as at 22 April 2022.
- 2 All market data included in this report are dated as at close 21 April 2022, unless a different date and/or a specific time of day is indicated in the report.
- 3 HSBC has procedures in place to identify and manage any potential conflicts of interest that arise in connection with its Research business. HSBC's analysts and its other staff who are involved in the preparation and dissemination of Research operate and have a management reporting line independent of HSBC's Investment Banking business. Information Barrier procedures are in place between the Investment Banking, Principal Trading, and Research businesses to ensure that any confidential and/or price sensitive information is handled in an appropriate manner.
- 4 You are not permitted to use, for reference, any data in this document for the purpose of (i) determining the interest payable, or other sums due, under loan agreements or under other financial contracts or instruments, (ii) determining the price at which a financial instrument may be bought or sold or traded or redeemed, or the value of a financial instrument, and/or (iii) measuring the performance of a financial instrument or of an investment fund.

© Copyright 2022, The Hongkong and Shanghai Banking Corporation Limited, ALL RIGHTS RESERVED. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise, without the prior written permission of the issuing entity name. MCI (P) 037/01/2022, MCI (P) 017/10/2021

[1191144]