HSBC Global Research

22 April 2022

The Major bond letter

#19. Warp speed

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Global

Star Trek's Enterprise[1] 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.

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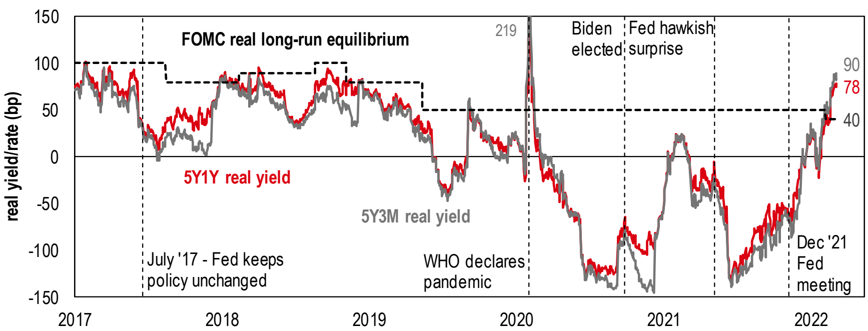
Figure 1. Real forward yields above longer-run equilibrium



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

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[1] Star Trek (TV Series 1966-1969)

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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".

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