The Major bond letter

#17. Hikes that won't stick

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Fixed Income – Rates

Global

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Front-loaded rate hike expectations are a response to persistent inflation. But the US bond market is questioning whether the hikes will stick. Ultimately, the debate comes down to two questions: (1) How fast will inflation fall in the coming months? and (2) Can central bank equilibrium rates be pushed higher this cycle?

The first question is the result of upside inflation surprises prevailing for more than a year, effectively refuting the 'inflation is transitory' view. Indeed, Fed Chair Jerome Powell has said it is time to retire the word *transitory* (30 November 2021). Having got something consistently wrong, rational forecasters will likely hesitate to make similar predictions. Once bitten, twice shy.

Persistent upside inflation surprises have contributed to a widening of confidence intervals around forecasts for lower inflation. For example, the Bloomberg consensus forecast for US CPI is for it to fall to 2.80% a year from now, whilst the level implied by the inflation swap market is circa 100bp higher.

This additional risk premium for swaps, versus the forecasts, probably incorporates the downward bias to inflation forecasts at a time of heightened uncertainty. Let's not forget: most forecasters were conditioned by a decade of disinflation in large parts of the developed world, so they were 'surprised' by the fall-out from the pandemic. Many are now questioning the assumptions behind their forecasts. But we cannot be too harsh, as policymakers around the world also missed the shift.

The inflation upside surprise had many sources, mainly emanating from supply-side disruptions related to the pandemic and, subsequently, the re-opening of some economies. This means the inflation has been broad-based and persistent. Prices of second-hand cars, airline tickets, rent, food and energy all contributed to the upside surprises of the last year.

Inflation is likely to fall in the coming months as some of the goods price inflation goes into reverse and base effects work through. This said, there are not many market forecasters in the mood to make a strong call. Those that previously forecast very low inflation have lost their voice. Sceptics justifiably ask: why wouldn't high inflation just persist for longer? Sticky inflation has become the prevailing narrative. It won't change until there is hard evidence in the data to the contrary.

The second question is on the equilibrium rate, the level to which central bank policy rates achieve neutrality; i.e. when inflation is averaging close to target and full employment has been reached.

Persistent inflation has resulted in a growing conviction that rates will be rising a lot this year. In just a few months, markets moved from anticipating three-to-four 25bp hikes to seven-to-eight this year. Our view is that the market is likely to gyrate between hawkish and dovish narratives, reflecting binary outcomes.

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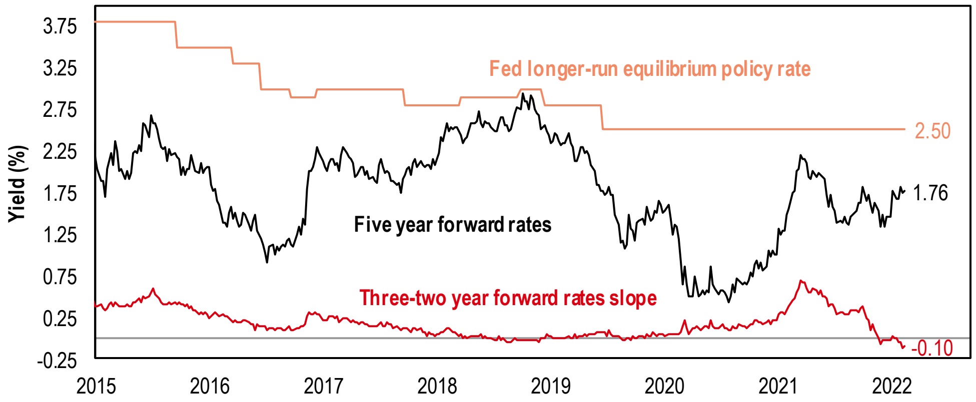
There is less conviction in the bond markets as to whether the longer-run equilibrium rate will be reached, let alone passed. Bonds are questioning the sustainability of high inflation expectations. Flat to inverted forward yield curves suggest recession risks, and the conclusion is that the terminal rate need not be pushed higher. At least that is the perspective of the bond market today, which appears to recognise that lower-for-longer yields have been the result of a multi-decade trend that pre-dates the pandemic and the Global Financial Crisis (GFC).

Figure 1. Inversion implies easing in two years – Forward three-month rates



Note: Weekly data, overnight interest swaps (OIS): five/three/two-year forward, three-month rates
Source: Bloomberg, Federal Reserve, HSBC

We use a five-year forward, three-month swap rate (black line in Figure 1) to estimate where markets see the policy rate peaking. The forward is comfortably below the Fed's own guidance for the longer-run equilibrium rate, so there is much at stake here because long bond yields are guided by this rate. Forward yield curves (red line) offer hints of recession and even the chance that the rate hikes of the next two years will be reversed soon after. Bonds recognise that rate hikes will be delivered, but question how far they can go if this is at the expense of growth.

So, what needs to give? For the bond bulls to be right, inflation must fall enough for tightening expectations to dial back to something more modest. For the bulls to be wrong, estimates of the equilibrium rate would have to be pushed higher, with forecasts emboldened by rate hikes being delivered at every meeting in response to stubbornly high inflation. By the summer, we will know more about just how sticky this inflation is.

Markets are not so patient. We note that the Reserve Bank of New Zealand (RBNZ) has just projected a higher equilibrium rate, lifting its projection for the cash rate by 75bp, from 2.5% to 3.25%. This is one for the hawks because it shows it can be done. The counterargument is that this may be a unique episode, consistent with a small open economy that has experienced a disproportionate fallout from the pandemic.

In the meantime, we are in debate mode, testing hypotheses, waiting for the rate hikes, and, along with the bond market, questioning whether they will stick.

Previous editions of 'The Major bond letter'

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