The Major bond letter

#36. Fly on the wall

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Global

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In just over three weeks, all eyes will be on Jackson Hole and the musings of the central bankers and academics in attendance. Following the recent shift in guidance from the Bank of Japan, along with rate hikes from the Federal Reserve and European Central Bank, this is arguably the next big event in the calendar.

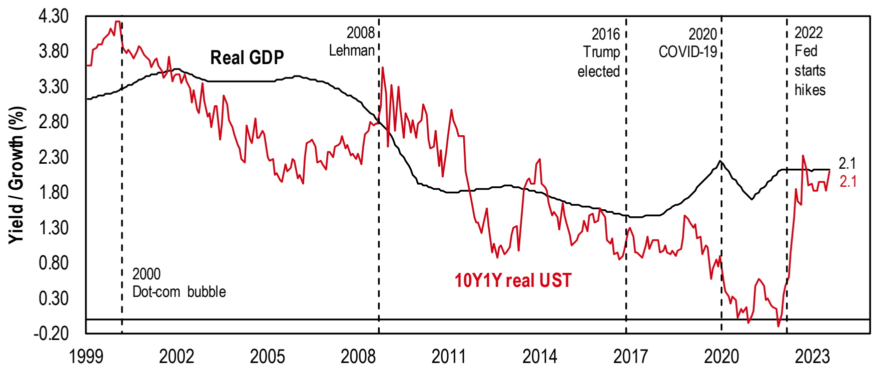
What we know about the 2023 Economic Policy Symposium (24-26 August) is that it is scheduled to debate *Structural Shifts in the Global Economy*, making it of particular interest to anyone interested in where bond yields might be heading. What we would give to be a fly on the wall!

When we see the word “structural”, we tend to think of the long-term determinants of equilibrium policy rates. Bond yields in their purest form are the equivalent of what could be received from holding a series of short-term money market instruments, such as bills. Today’s policy rate is only the first part of what we need to value a 10-year maturity bond. We also need to know – or at least be able to estimate – the expected path for rates, and crucially, the longer-run equilibrium.

Through most of the last three decades, the US estimate of the longer-run equilibrium real rate – the nominal policy rate adjusted for inflation – has been falling along with the trend rate of growth. An official estimate of this equilibrium – where the economy is at full employment with inflation at target – can be derived from the Fed’s longer-run median “dot”, which has fallen from 2.25% when records began in 2012, to 0.5% in the most recent edition. These calculations for the projected real rate take the 2.0% inflation target and deduct it from the nominal figures provided in the Fed’s Summary of Economic Projections.

Our chart is another take on linking the real rate to the economy, this time using the bond market’s estimate for the 1-year rate in 10 years’ time, and a 10-year moving average for real GDP. Most noticeable is the suggestion that something has changed from the recent surge in the forward real rate and the uptick in the GDP trend.

Trend GDP and market-implied real rate



Note: 10Y moving average of real GDP growth and 10Y forward 1Y TIPS real yields used
Source: Bloomberg, HSBC

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Solace for bond investors today comes from the experience that the real rate rarely stays above the trend GDP for long, the inference being that there is a limit to how far rates can rise before the economy slows. Furthermore, the uptick in the trend GDP line takes it above the Fed's projection of 1.50-2.0%, which means our estimate for growth is on the generous side.

The high-altitude discussion around structural shifts in the global economy will ultimately try to address whether something has fundamentally changed. Or, could it be that the shift indicated by the market will prove to be an aberration and, once the disruption of the last few years has been allowed to work through, rates and the economy will return to the low pre-2020 levels?

Explanations for the previous decline in real rates and trend GDP include ageing populations, debt overhangs, productivity, inequality, and technological progress. But recent years have brought new challenges to assumptions regarding the structural backdrop of low equilibrium rates, particularly from the fiscal policy side. These include – but are not limited to – spending to ensure economic recovery from the impact of the pandemic, financing the transition to net zero, and increased defence spending at a time of heightened geopolitical uncertainty.

To be clear, when discussing structural shifts, policymakers are looking beyond the near-term data releases and cyclical patterns. They could well, however, debate whether evidence of such structural shifts is now having a significant impact on this data. For example, inflation may have been falling recently, but has something happened to stop it returning back to target within the forecast time frame? Similarly, has there been a permanent shift in the structure of the labour market such that wage growth will remain sticky?

Without access to the Jackson Hole presentations, and the debates that go with them, we can do little but wonder and wait. One thing that has changed, and might be considered structural, is the widespread deficit spending by governments, entailing a boost to demand that may have added to inflation pressure. If fiscal loosening has added to inflation, then maybe it should be reversed? Easier said than done, given that it would be politically unpopular.

Markets may crave some more certainty on the outlook from the discussions coming out of the Symposium later this month, but will be mindful that the agenda can be overrun by events. Last year's theme was *Reassessing Constraints on the Economy and Policy,* but it will instead be remembered for the Fed cementing its hawkish turn on inflation and rates. Likewise, the year before, talk of the Fed's QE taper overshadowed *Macroeconomic policy in an Uneven Economy.*

Of course, market estimations of the real rate could just be wrong. We have made the argument that there is a high risk premium embedded in the forward rate which reflects policy uncertainty (see *The Major bond letter #31. See-saw,* 20 March 2023). In other words, investors are already compensated for the possibility that something has changed. It's one thing to claim there has been a fundamental structural shift, explain what's behind it, and then argue that the market should reprice accordingly. But it's totally another to say the market valuations have moved and that this means there's been a structural shift.

In the meantime, we will just have to use our imagination. Anyway, the proverbial fly on the wall may just find the altitude sickness too much to bear.

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#3. *New year, old narrative*
#4. *Beneath the surface*
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#6. *Treasuries and trees*
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#8. *Lucky number*
#9. *Stuck in the middle*
#10. *Taper and the Hole*
#11. *Every basis point counts*
#12. *Push back*
#13. *Game of chicken*
#14. *Across the pond*
#15. *The most insightful question*
#16. *QT teaser*
#17. *Hikes that won't stick*
#18. *China-US divergence*
#19. *Warp speed*
#20. *Usefully wrong*
#21. *Second half narrative*
#22. *Curve cacophonia*
#23. *Breathe (in the air)*
#24. *EM reaps rewards*
#25. *The Grizzly*
#26. *Bring it on*
#27. *Funny old game*
#28. *Japan's curveball*
#29. *The penultimate hike*
#30. *Score draw*
#31. *See-saw*
#32. *Emerging Victorious*
#33. *Mind the gap*
#34. *Addressing 'higher for longer'*
#35. *Great divergence, revisited*

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