The Major bond letter

#21. Second half narrative

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Fixed Income - Rates

Global

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Markets love a narrative. And they do not hesitate to switch from one to another. Preceding the "Bernanke taper tantrum" was Greenspan's "put". So get ready to read about the "Powell pivot 2.0", surpassing the first, after the short-lived QT (2018-19). What will follow today's narrative of the "great inflation"?

Narratives are appealing because they can provide a simple explanation to something that may otherwise be rather complicated[1]. So whilst central bankers – and research analysts – delve into analysis of how an exogenous supply-side shock has contributed to upside inflation surprises, others explain the changes as caused by COVID-19 or the war in Ukraine.

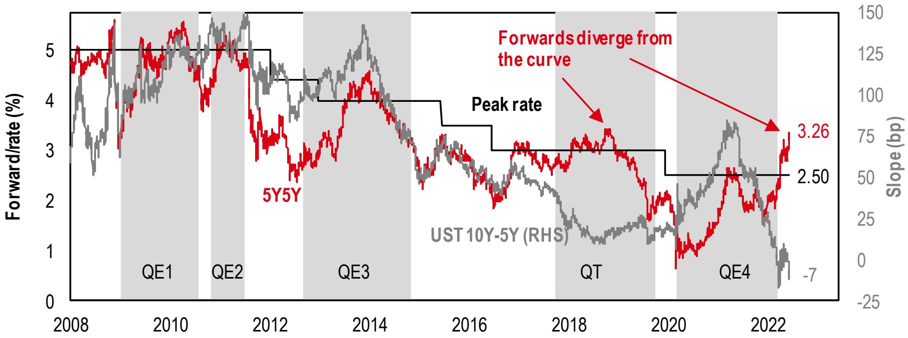
In reality it is never so simple. Indeed, it is not our opinion, or any particular school of thought about the cause that matters, rather the collective wisdom of the entire market.

The prevailing narrative, right or wrong, gives us the valuation. This was described by the Keynes' newspaper contest where the winner does not put forward their own preference, rather correctly identifies what's attractive to the majority of the other participants.

And so it is in markets. The consensus forecasts and forward yields move *as one* but both can prove to be horribly wrong when the narrative changes. It is not rare for realised bond yields to be 100-200bp above or below where they were projected to be a year before.

The recent response of the bond market to the "unanticipated" rise in inflation resulted in a similar upward yield shift to the "taper tantrum' of 2013 (see Figure 1). Back then the narrative was that the Fed had done a handbrake turn on bond purchases, signalling a shift from QE-infinity to QE-end in the space of a few months. We remember there was more to it, not least the global context, and then ECB President Draghi's "whatever it takes (2012).

Figure 1. Forwards, curves and peaks



Source: HSBC, Bloomberg. Note: 'Peak rate' is based on previous rate peaks and longer-run 'dot'. Grey shaded areas indicate QE programmes.

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[1] Narrative Economics: How Stories go viral and drive major economic events, Robert Shiller, 2019

Now, 10-year bond yields are more than 150bp above where forwards projected them to be last year, and based on the recent "dot plot", 3.5% is closer to the FOMC's median projections for the policy rate in the next two years. This peak may yet prove to be higher than the last cycle – although we are not there yet – but this does not mean that the longer-run equilibrium has to move up by the same amount.

Otherwise known as the terminal rate, the longer-run equilibrium – according to the June dot plot – is projected to be 2.50%, the same as the peak from the last cycle. Given the current predicament, there is nothing inconsistent with policy rates going to 3.50%, or above, before settling down around 2.5%.

Two narratives are simultaneously driving the curve. One is that a hawkish Fed is responding to the unacceptably high inflation, pushing short yields up. The other is shown by resistance at the longer-end, flattening of the curve, a narrative shift to weaker growth, and the low longer-run equilibrium rate.

The chart shows divergence between the flattening 5-10yr segment of the Treasury curve compared with the five year forward (5Y5Y). Most clear is the difference between this cycle and others, particularly 2013.

The curve steepened in the 2013 taper tantrum, which contributed to the shift higher in the 5Y5Y. Now the curve is flat, and inverted in parts, so it means the forward and spot yields are similar. As the Fed stepped up its hawkishness in recent months – with 25bp increases becoming 50bp, and now 75bp rate hikes – expectations in the forwards, that yields could have peaked already, have been proved wrong by events.

Our narrative has been a game of two halves. This entails a peak in yields in the first half of the year, followed by a decline in the second half.

If this was a game of football (soccer to our American friends), we would have reached the final minutes before the half-time whistle is blown. One team is comfortably on top and the manager is thinking how to protect the lead, maybe keep it tight at the back, bring on a defender. Meanwhile, the manager of the losing team is thinking hard about substitutions, praying for a change of fortune, maybe an own goal or even a red card.

The Fed's robust response means there is already an increasing probability of recession in 2023, and this will likely be reflected in cuts to forecasts for GDP and employment through the second half of this year. Inflation may even start to ease in response. Given the Fed has a dual mandate, to manage both employment and inflation, the narrative shift could be consistent with less hawkishness as the second half of the year develops.

The bond market has had a terrible first half. But the second half has yet to be played and it is always possible that the losing team may start to turn things around in the second half.

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