12 June 2023

The Major bond letter

#34. Addressing ‘higher for longer’

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Global

‘Higher for longer’ has become a meme in the rates markets, sometimes used to contrast with ‘lower for longer’, itself a shorthand description of what went before.

We understand ‘higher for longer’ as the idea that rates will have to stay at a peak for longer than before. We are hearing it so much these days that it seems to have become an accepted truth. Say something often enough and people will start to believe it. However, to move yields up (prices down) in a way that is relevant to investors, the policy rates would have to be held at a higher level for longer than valuations imply.

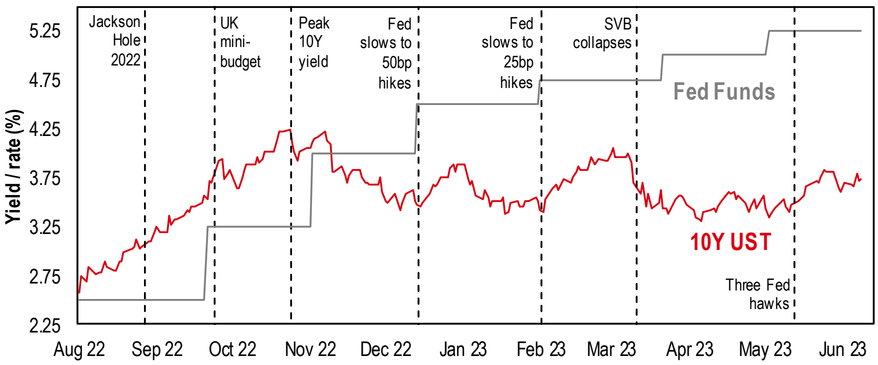
For all the chatter, long-end yields have been resisting the increases in the policy rate for the last eight months. We can see this in our chart. Since 24 October last year, the US Federal Reserve has increased its target rate five times (and could go again). The hikes totalled 200bp, delivered as 75bp in November, 50bp in December, and then three 25bp hikes in 2023.

With rate hikes decelerating, the yields on the longer maturities fell. Bonds are doing what they are supposed to do, looking through the noise and reflecting where the policy rate will be in the years to come. Policy rates up 200bp, 10-year yields down 50bp.

We took a closer look at where ‘higher for longer’ came from, what it actually means, and why it matters to bond markets. Five points stand out.

First, we believe the phrase gained traction last November with Fed Chair Jerome Powell’s response to questions: “We’ve always said it was going to be difficult, but I think, to the extent rates have to go higher and stay higher for longer, it becomes harder to see the path”. This was in a post-FOMC press conference (2 November 2022) following the third hike of 75bp and, as it transpired, the final increment of this size. We note that these are not words from the official statement, but rather a response to a question about a soft landing. Like ‘lower for longer’, it is a form of forward guidance that policymakers have been backing away from.

Bond yields resisting the policy rate hikes



Source: Bloomberg, HSBC

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Second, we wonder about the word choice and context. This was at a time when inflation had been consistently above the Fed's projections, challenging its credibility. If the use of 'higher for longer' was meant to counter the implication of a premature return to lower rates, given that the Fed is forecasting a soft landing, it's not perfect.

Anyway, the antonym for 'higher' is 'lower', whilst for 'longer' it is 'shorter'. We think 'higher for shorter', though a more awkward phrase, could be the correct opposite of 'lower for longer'; but it conveys a different message – if history is any guide, a short period of high rates would most likely be ended by a hard landing, or some sort of disruptive event, and this is neither the Fed's base case nor its policy intention.

Third, today's 10-year yield reflects a range of scenarios and a weighted average of plausible outcomes. The market does not know with any certainty what the next rate move will be but, whilst it prices in the likelihood that there might be another small hike, it reckons that the next big move in rates is down. If the probability of a hard landing was seen as greater than the soft variety, then the market could work out that rates are more likely to be cut in much larger increments than 25bp.

Fourth, when the dot plots are giving rate guidance, at least consistent with the economic projections, it is hard to get away from the fact that they project a longer-run equilibrium around 2.5%, which is half of the current policy rate. Central banks may prefer not to pre-commit, letting the incoming data speak for itself, but the market looks at the guidance and makes its choice. The five-year forward yield is 150bp below today's policy rate and about 100bp above the longer-run equilibrium in the dot plot. The market has priced in a peak for rates followed by a large decline to a level already comfortably above the Fed's guidance.

Fifth, the repetition of a plausible truth can result in people believing it regardless of whether the original source was credible or not. The illusory truth effect[1] occurs when people start to believe easy-to-process statements. It's much easier to believe something when you've heard it before and it has already sunk in. This could be the case with something that trips off the tongue, like 'higher for longer'. It was uttered once in answer to a question in November 2022, but has since been repeated many thousands of times by market participants.

Given that most of us don't bother to check sources, if we hear the same thing five times from five different people, it might as well have been from the same person five times. When it comes to (mis)remembering it, the central bank's response to persistent inflation has become that interest rates are going up and will be 'higher for longer'.

Bond yields are caught between the pull that rates will return to their previous low levels and the push that they will need to stay higher. If this was what the Fed was hoping would happen, then forward guidance is alive and well.

Higher-for-longer rates are often presented to us as a pushback to the theme of lower-for-longer rates – but, as we have shown, like any superficial truth, it is far from a perfect predictor.

[1] L Hasher, D Goldstein, and T Toppino, *The illusory truth effect* (1977)

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