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Special Report: A Primer on the Fed

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IN THIS SPECIAL REPORT

A PRIMER ON THE FED

- Now that the Fed has got the market reset for 4 rate hikes this year, I think the bigger surprise will be a quicker taper and move to QT because it is the most efficient way to cool demand without crushing it
- That means the Eurodollar futures are attractive, the conditions for a steepener in the Treasury market curve led by the front end look like a solid bet, and I would expect to see spread products begin to widen out
- What's been happening of late is that the Treasury market has done its repricing of the Fed and the stock market is following with a lag
- And mostly importantly: don't ever mess with the yield curve — an inversion of the 2s/10s curve has foreshadowed all six recessions in the past 40 years (it has never flashed a "head fake")

A PRIMER ON THE FED

There are too many rate hikes priced in, but the big deal is the end of QE and the onset of QT (farewell to the "wealth effect" on spending).

You look at the correlations and they say a lot. When it comes to the balance sheet, it has 90% correlation to the stock market but less than a 50% correlation to GDP. You go to the funds rate, it has only a 25% dampening effect on the stock market but an 80% negative impact on the real economy.

So what I'd be looking for now that the Fed has got the market reset for 4 rate hikes this year (and it is going to start in March, of that there is little doubt because Biden has already given a nod and all the FOMC doves are on board) is that the bigger surprise will be a quicker taper and quicker move to QT, and that is because it is the most efficient way to cool demand without crushing it. But the real damage is going to be for risk assets, and when you read the minutes from all the meetings of the past year, it is clear that the Fed is at least as concerned over asset bubbles as much as it is concerned that we have hit the wall on labor supply. And, in fact, one of the basic supporting mechanisms for this "Great Resignation" theme is this ingrained belief that people don't have to go back to work because of their bloated portfolios. Creating the conditions for a new and lower range for the equity market is going to suit the Fed just fine, and the Fed is a big believer in the equity and housing wealth effect on spending and that this runs in both directions.

Interest rates are a hammer on Main Street, and a smoother way to cool demand without generating a recession will be to take the excessive valuations out of the equity and real estate markets via ending QE rapidly and shifting earlier to QT — and so the mechanism will be to curb demand and the role it has played on inflation through Wall Street and the knock-on effect this will have on Main Street, but will have a bigger impact on the "well off guy" than the "little guy" who will get hurt more by borrowing costs going up sharply. All roads towards reducing demand growth will come via reversing the wealth effect, and that in turn means hedging all cyclical exposures in the asset mix.

So at this point, based on what's priced in, I think the surprise will be that the Fed does less (not more) on rates, and that means the Eurodollar futures are attractive, the conditions for a steepener in the Treasury market curve led by the front end look like a solid bet, and I would expect that we will also see mortgage spreads, and in fact all spread products, begin to widen out — especially so in the high yield market where investors seem to be living in a la la world of zero defaults. So part of this trade includes trading up in quality.

There is a view out there that QE was a way to lower bond yields as the Fed hoovered up Treasury securities, but in actuality, there was a powerful offset from this sort of policy stimulus via generating a private investor shift to risk assets. That was always the game with QE, and Ben Bernanke made it clear on the eve of "Round Two" in 2010 that this strategy was aimed principally at triggering a positive wealth effect on spending. In fact, most of the time during the recurring "Helicopter Ben" attempts at QE, Treasury yields rose, they didn't fall. The investor "animal spirits" caused them to shift their asset mix from bonds to stocks and that had an over-riding impact on yields that swamped the fund-flow impact of the Fed "taking Treasuries out of the system." The critical stimulative impact came from the wealth effect from asset inflation as well as by pulling down the equity cost of capital and multiples soared to levels we have only seen 2% of the time in the past century.

Examples:

From December 2008 to August 2013, the Bernanke Fed took the balance sheet from $2.2 trillion to $3.6 trillion — a 64% expansion. Now how did that turn out for the 10-year T-note? Not so great — because the yield jumped from 2.4% to 2.7%. What happened? Well, the portfolio rebalancing out of bonds and into stocks overwhelmed the Fed's move to hoover up Treasury securities.

When the Fed finally ended QE in 2014 and kept the balance sheet unchanged (at $4.4 trillion) through to 2017, the 10-year T-note yield was range-bound with a low of 1.6% and a peak of 2.9%, and spent most of the time hovering around the 2% mark.

From January 2018 (when Powell took over at the helm) to September 2019, the Fed's balance sheet went from $4.4 trillion to $3.8 trillion, for a 14% reduction. Over that time, the yield on the 10-year note went from 2.8% to 1.5%. Of course, the prior expectation that the Fed would take the funds rate to 3% ended up being a peak of 2.5% and then what happened (with perfect hindsight) was that the funds rate was adjusted lower to just over 2% at the peak of the QT in September 2019. This is what I am saying — moving to QT this time will also likely imply a lower peak in the funds rate than is currently priced in. And if I'm right that the Fed can't take the funds rate above 1% this cycle without incurring some major damage to the demand side of the economy, then we should end up seeing the 10-year settle back into a range where 1.5% will be the midpoint.

This, in fact, is what Ben Bernanke penned on November 4th, 2010 in a Washington Post op-ed piece, after he unleashed QE2 — a spirited defense of his actions:

> *"Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment.* ***And higher stock prices will boost***

> ***consumer wealth and help increase confidence, which can also spur spending.*** *Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*

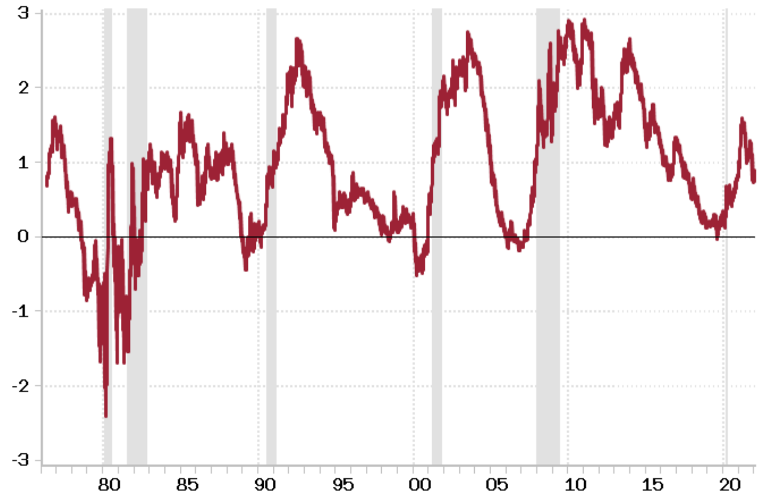
The wealth effect on spending wasn't such good news for Treasuries as it turned out but it sure was for the stock market. Where in that Bernanke comment is there anything you can construe as being positive for bonds?? It's all about "take on more risk!" But now this movie is about to be run in reverse, so please be prepared for a switch to a different paradigm, one in which the Fed no longer "has your back" as an investor. That day will return, but not until the bear market really takes hold… this thing is just starting, and we haven't even seen spillover to the riskiest tranches in the credit market yet. And Powell, being a credits guy, has only in the past responded when the tightening in financial market conditions begins to seriously affect the market for corporate credit, which was the real story in late 2018 and again in the winter of discontent in early 2020 when these areas of the market completely froze up — the equity market was a side show next to the blow-up in high yield spreads.

Now what is happening, obviously, is that the Treasury market has done its repricing of the Fed and the stock market is following with a lag. And what people miss when they talk about QE and bond yields is the portfolio shift that takes place when the risk-off trade dominates, and that is what we have seen happen in the past two weeks. As a template for what I am talking about, we have seen the 10-year T-note yield dip 3 basis points since January 10th, and it's fully due to the S&P 500 correcting 6% and the Russell 2000, which has the pulse on the domestic economic outlook, dropping 8.5% over this short time frame. But it is instructive and speaks to the 70% inverse correlation between pricing in the Treasury market and pricing in the equity market, which is why calls for the end of the 60-40 asset mix will never be right, and that is because Treasuries are still a terrific risk-diversifier and have zero capital risk.

One other thing, and this has to be stated emphatically: don't ever mess with the yield curve. The 2s/10s spread is now 74 basis points; far below the long-run mean of 100 basis points. This means, at least based on its current shape, the Fed really can't do what is now priced in, which is move four times this year without inverting the curve. **An inversion of the 2s/10s curve has foreshadowed all six recessions in the past 40 years. It has never flashed a "head fake." It has a 100% track record; an inversion is both a necessary and sufficient condition for a recession, and no other "market signal" has this uncanny ability to signal a turning point in the business cycle.**

CHART 1: Don't Mess With the Yield Curve!!

United States: *2s/10s yield curve*
(percentage points)



Shading indicates recession
Source: Haver Analytics, Rosenberg Research

Powell made the policy error of allowing the curve to invert even a modest 4 basis points in late-August 2019, so guess what? A recession was coming, likely a mild one, even if the COVID-19 pandemic and the messy lockdowns in March-April 2020 hadn't come our way.

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