SOM
Macro
Strategies

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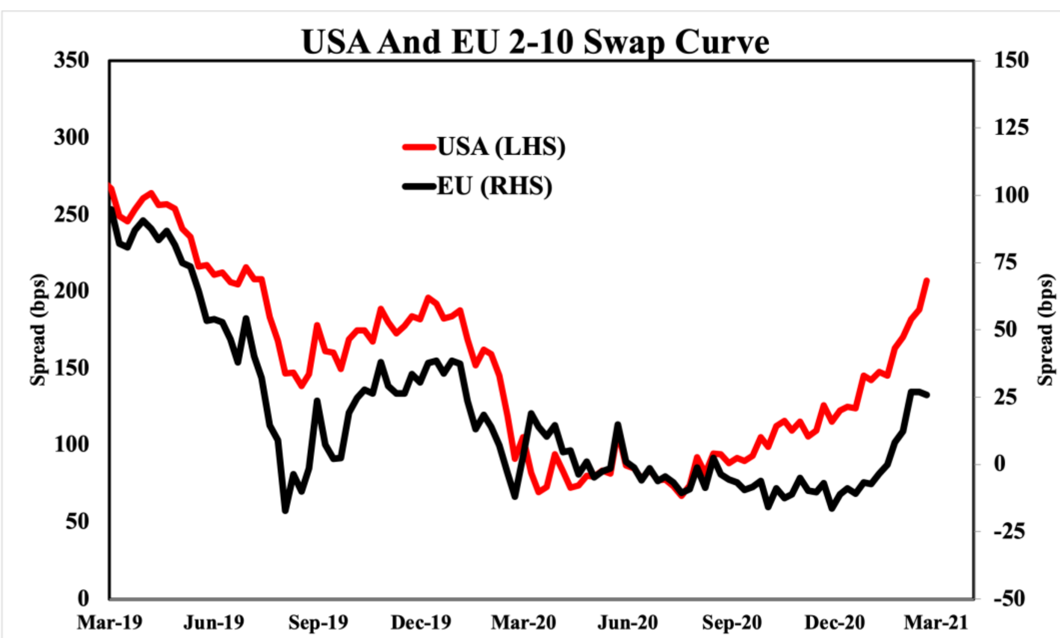
State Of The Markets: Macro Commentary

Normalization Means A "New Normal" Of Higher Rates

The recent steepening of yield curves has been rapid and substantial, bringing curves in both the US and Europe back close to their pre-COVID levels, Figure 1. Not a surprise, given the normalization of economies from the ebbing of the COVID pandemic from the acceleration in vaccinations and the subsequent emergence of economic growth. However, the question now: is the repricing done with levels back to the old normal levels? My answer is no, and over the near-term rates markets are entering a "New Normal" with higher-than-normal historical levels of US rates, and potential with more upside in rates than markets are pricing. This "New Normal" is being driven by three factors:

- The Fed and ECB have slowed their pace of QE, which has effectively ceded control of the long end of the curve to forces that will continue to push yields higher and curve steeper as the normalization accelerates.
- Inflation and yields could go higher as normalization allows the private sector to turn their historically massive cash holdings into spending.
- Upward pressure on yields could be grow from the increase in the supply of Treasuries. Deficit funding needs are going to be even greater in 2021 than it was in 2020, while demand from the Fed's QE plan is slowing.
    - Even more cash from stimulus is coming in the US, first from the $1.9 trillion soon to passed and potentially another round late in the year from Biden's fiscal policy initiatives such as the "Green New Deal".
    - Even more supply could be hitting the long end of the curve if the Treasury converts the historically large amount of Treasury Bills, they issued in 2020 into longer maturity debt.

Figure 1



The first factor is the slowdown in Central Bank QE. Yield curves in the US and Europe have steepened as yields in the curve's long-end rose while Central banks continued to keep short-term rates close to zero, Figure 2. Central Banks have effectively lost control long-end of the curve because they have reduced QE's pace, Figure 3. As a result, longer-term yields have started to rise, reflecting expectations of the impact of the normalization of economic growth. Growth is accelerating as the pandemic slows with vaccines' introduction and the likely uptick in consumption supported by the stimulus of 2020 and now the 2021 stimulus. In the "New Normal", yields could overshoot historical norms particularly if Central Banks continue on this slower path.

Figure 2

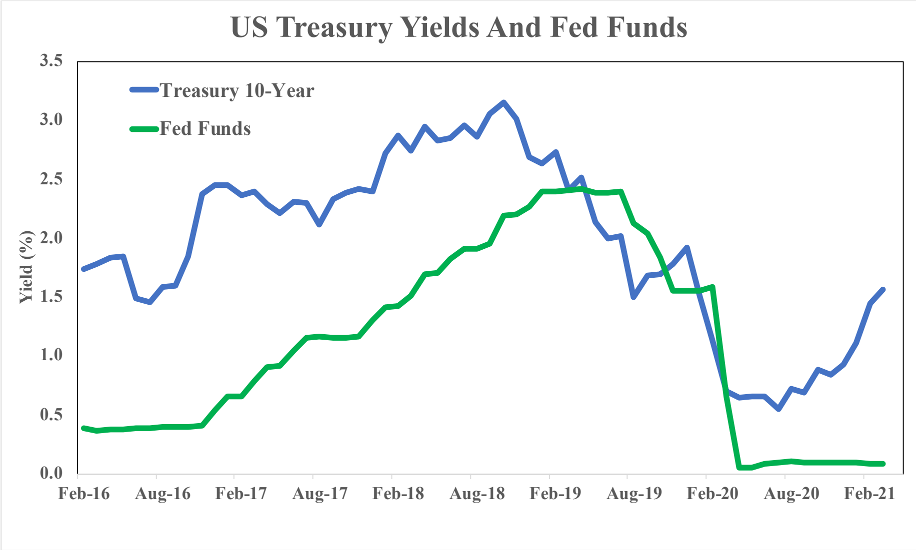
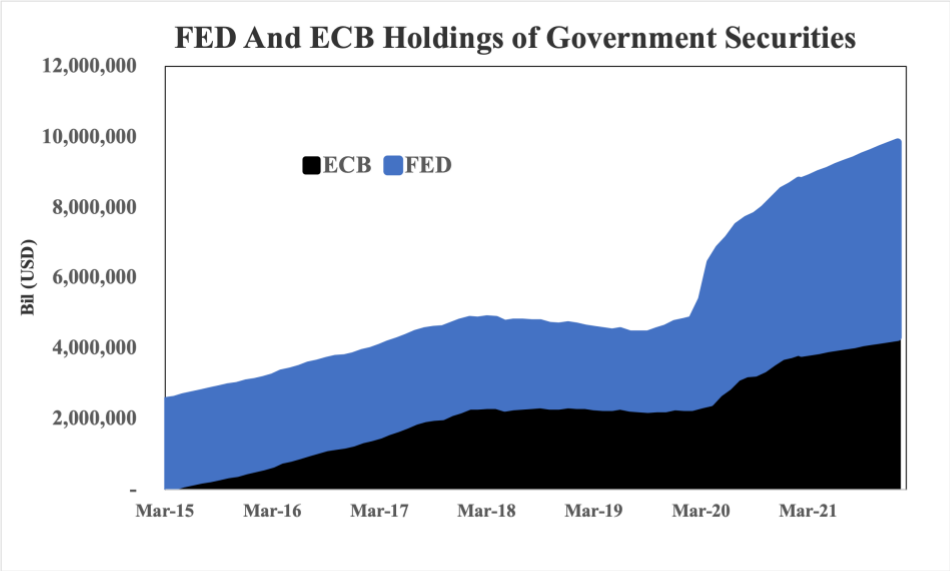


Figure 3



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The second factor that could push long-end yields higher is inflation expectations. As I talked about in my piece of late December, Figures 4 and 5, the rise in the money supply used to offset the economic slowdown ended up as higher private-sector cash holdings but not in higher consumption. Higher cash holdings pushed down the velocity of money and reduced inflationary pressures. However, as the negative impact of COVID on consumption ebbs, the private sector could turn that cash hoard into consumption. If the Fed chooses not to withdrawal reserves, that rise in velocity could become inflationary.

Figure 4

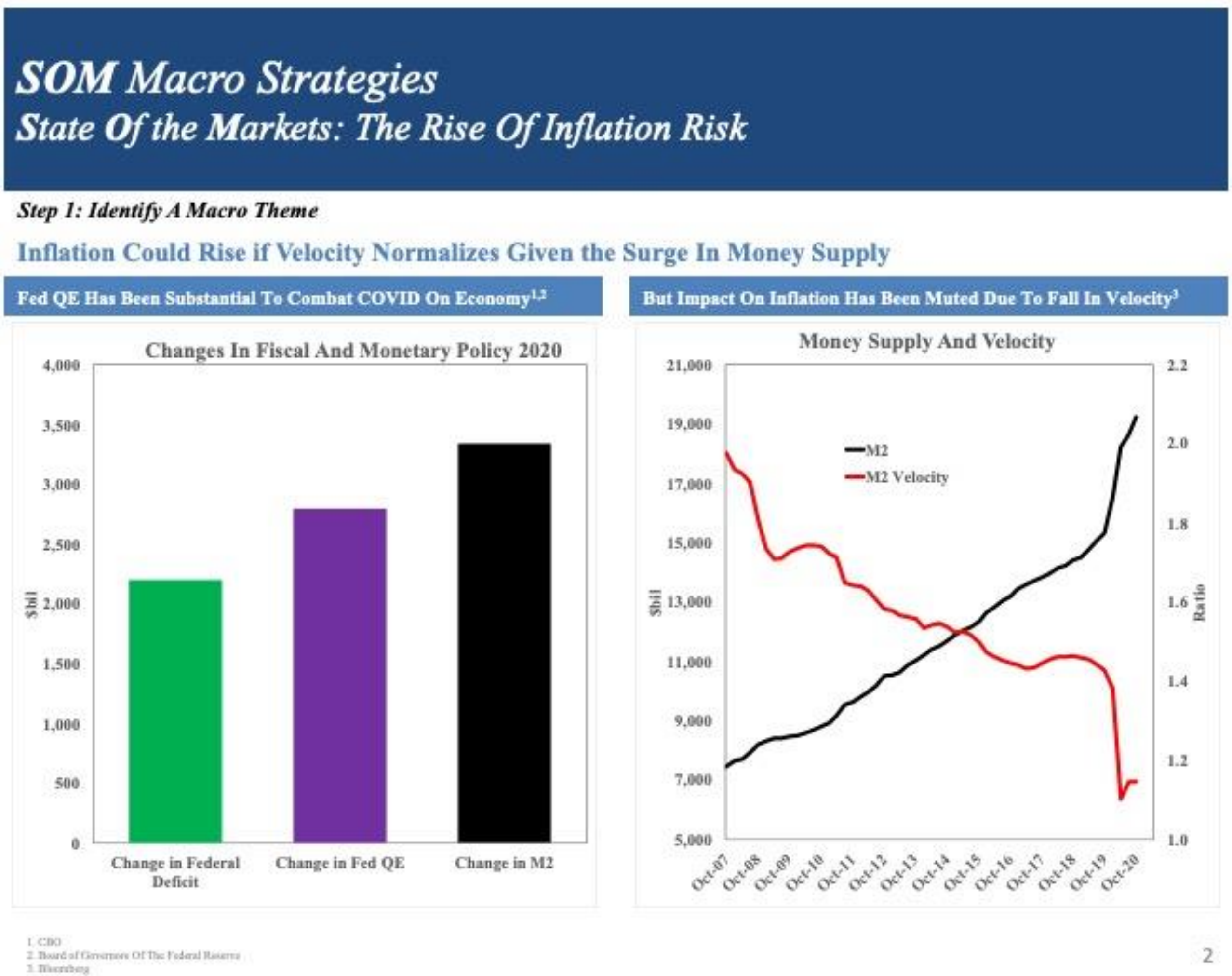
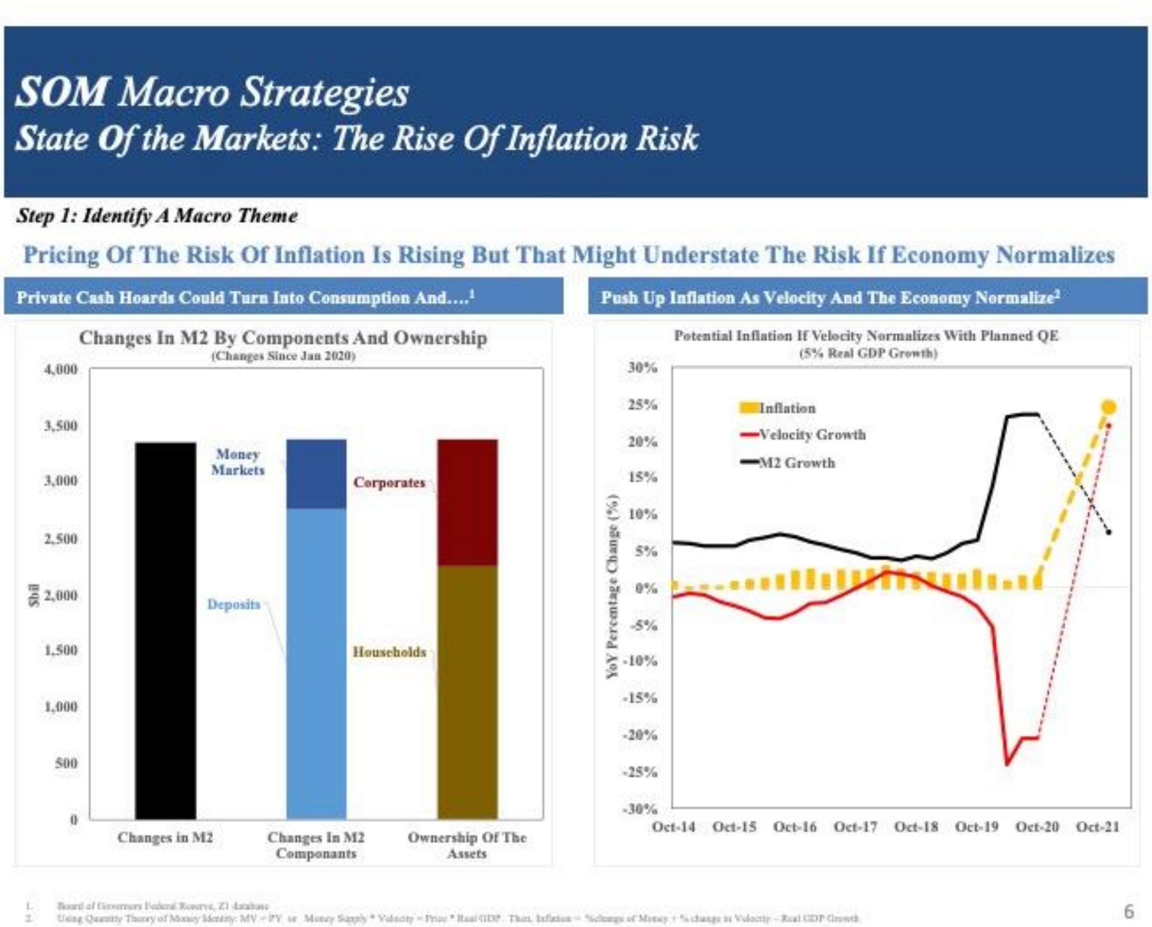


Figure 5



The third factor is upward pressure on yields from the growth in new Treasury supply. As shown in Figure 6 below, Treasury supply could ratchet up substantially to fund the deficit that will almost double versus 2020, given the passage of the $1.9 trillion stimulus package. Potentially adding to the deficit and corresponding Treasury supply funding would be the passage of Biden spending initiatives, which could come towards the end of the year. Adding to this pressure on the long-end is the potential that Treasury will convert a large amount of Bill issuance from the March/May stimulus funding to longer-term debt, Figure 7.

Figure 6

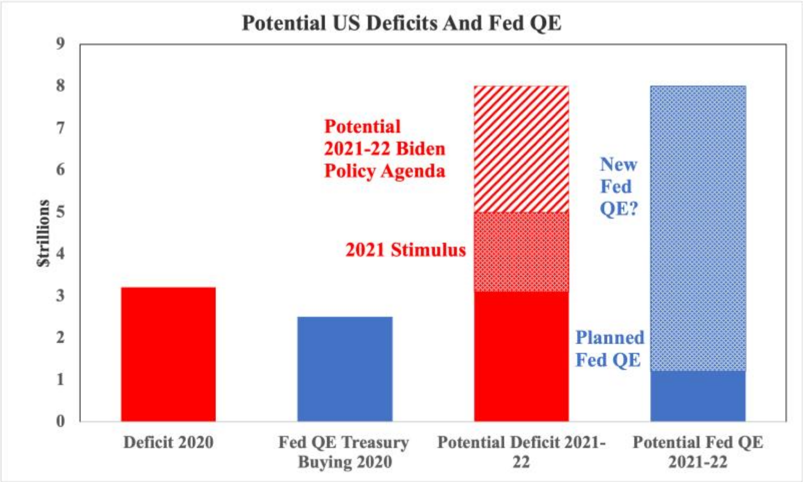
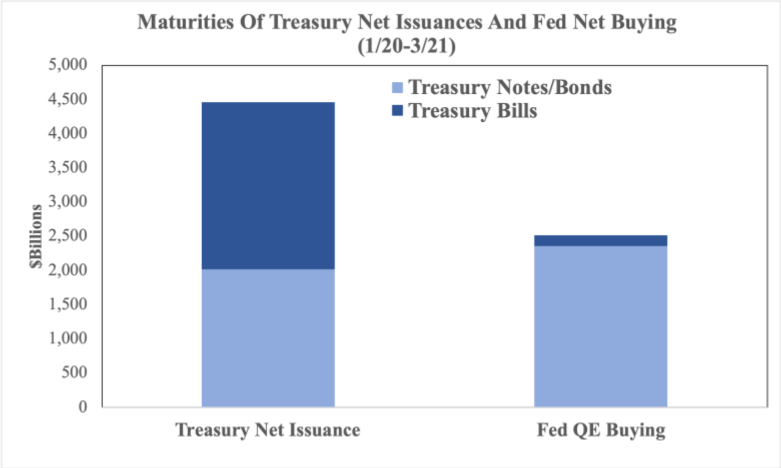


Figure 7



Even without a Biden fiscal spending initiative, the Fed will be between a rock and a hard place. They will either have to more than triple QE to offset the impact of Treasury supply and risk a substantially weaker USD and put more upward pressure on inflation expectations or let the long-end go and potentially push up yields and put the economy into a recession.

So, What To Do?

I am still long inflation swaps but could also see investors putting on curve caps. I am still long my equally weighted S&P trade. Rising rates will not be enough to outset a normalizing economy's power forces with consumers with a lot of cash to spend. I will send out a piece covering all my recommendations next week.