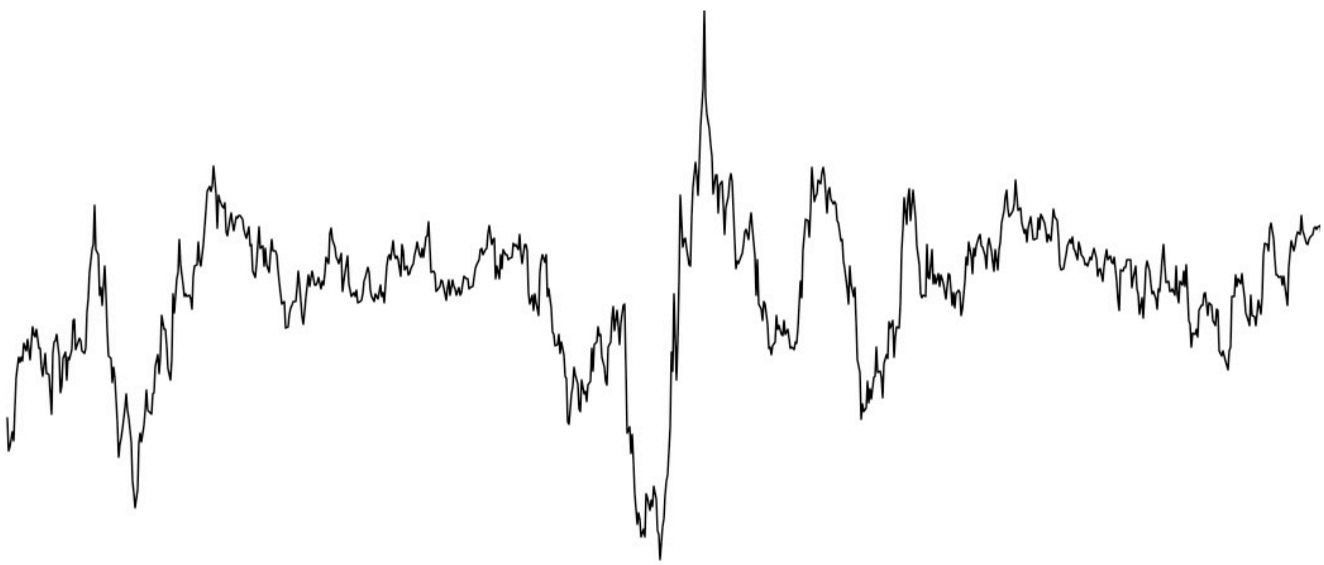
# ALPHA SOURCES

JULY 20, 2021



# SAME OLD, OR A NEW, STORY?

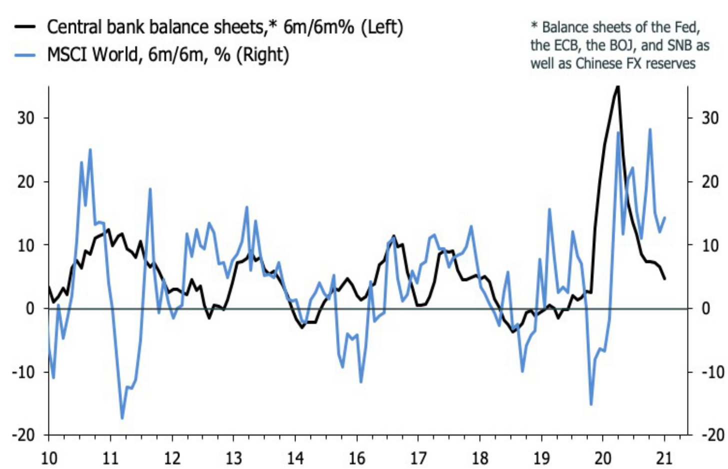
Markets have been propelled by a fairly simple story in the past nine months, split across two themes. First, market prices have been driven by the expectation that vaccination will once-and-for all allow us to put the virus in our rear-view mirror, and secondly, that fiscal and monetary policy will remain primed for support. This story was always going to be challenged at some point in 2021 as vaccination programs reach their climax and policymakers inevitably begin to consider what degree of stimulus that is needed in a world *not* in the grips of a pandemic. And wouldn't you know it; here we are. As far as the success of the vaccines is concerned, it is crucial to remember that the final path to a full reopening is as much a question of politics as it is about epidemiology. Indeed, at this point, I am inclined to believe that it is mostly about politics. This isn't surprising. Cases were never going to zero—at least not if we keep testing at the rate we're doing at the moment—and new variants were always going to elude the vaccines, one way or the other.

The rational response to this inevitability is to stick to reopening as long as the health system is not overwhelmed. This sounds great, but it is difficult in practice. The question is not so much whether any new variant is the ultimate vaccine-buster, but whether politicians, their experts, not to mention people at large believe it is. The bar for drawing such a conclusion probably is lower than many expect.

Many people predictably suffer from a version of Stockholm syndrome after a nearly 18 months in lockdown, and this obviously affects politicians' response. If people want safety, that's what political leaders will deliver. Using Europe as an example, this currently seems to deliver an equilibrium in which politicians are attempting to reopen fully at home, while maintaining a web of Byzantine rules for international travel. This is not, however, a stable equilibrium. Either reopening a home, drives a relatively quick reopening of travel between countries in which the majority of people—+75% have been double-jabbed—or travel jitters feed back into the re-imposition domestic restrictions, eventually. Some version of vaccine passport is probably inevitable, for certain activities. But it is not a silver bullet. Some people won't be vaccinated, come what may, and politicians mainly will be making their decisions in response to new variants, which, by definition, will be more or less vaccine-resistant.

At this point I am agnostic as to which way the pendulum swings, though it is now clear that reopening is not going to be as smooth as we expected. In the UK, for example, we celebrate "freedom day" on Monday the 19th amid clear evidence of a

**fig. 01** / A hiking cycle next year? - **fig. 02** / No gas left in the tank?

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fourth wave in new cases, still-volatile and unpredictable travel restrictions, and huge numbers of people forced to self-isolate on command of the track-and-trace app informing them that they have recently been in contact with an infected individual.

This reality could become an issue for investors. Markets have discounted the end of the pandemic since Pfizer announced its initial vaccine results in November last year. I fear that they might soon have to contemplate an alternate reality, and given how strong the response to the upside in November, the reaction could be scary to behold.

Worrying about a return of stop-start economic activity and new virus restrictions by definition means that you should worry less about the withdrawal of policy stimulus. This could be a cruel, though entirely, logical silver lining for markets. I think it is perfectly reasonable to the except a rally in so-called growth stocks to support the wider market in a world where the virus continues to throttle economic activity. Obviously, there is a tipping point beyond which everything unravels, but unless we're thrown back into the same cave as in H1 last year, a pleasant equilibrium from "growth" stocks, and bonds is possible.

Before we get to that, though, I think many analysts have been overthinking the recent rally in the US long bond. One story triumphantly goes that yields always fall when the Fed threatens to slow bond purchases, and vice versa when QE is ramped up, in contrast to the first principle's effect of such policies on market yields. I doubt it.

First, bonds are discounting the near-universally accepted fact that inflation, and economic momentum, almost surely will be lower 12 months from now than it is today. This, in fairness, is scant consolation for the Fed. Even if inflation goes down, it might still be too high comfort.

This brings me to the second, and key, point. **The announcement by the Fed that it is now considering when and how to taper QE isn't the issue, the leap in short-term bond yields is.** Markets now have to contemplate that fact that a hiking cycle will begin as soon as next year, which they seem to interpret as a policy mistake in the making.

The first chart above shows that the 22-21 EDZ spread widened, while the 22-23 spread has narrowed. In short, a hiking cycle, if commenced, will be short. My argument is not directly testable, though it comes with an easily falsifiable hypothesis. If the Fed puts the front-end back in the box—forward guidance could do this—I'd expect 10-year yields to rise.