ALPHA SOURCES

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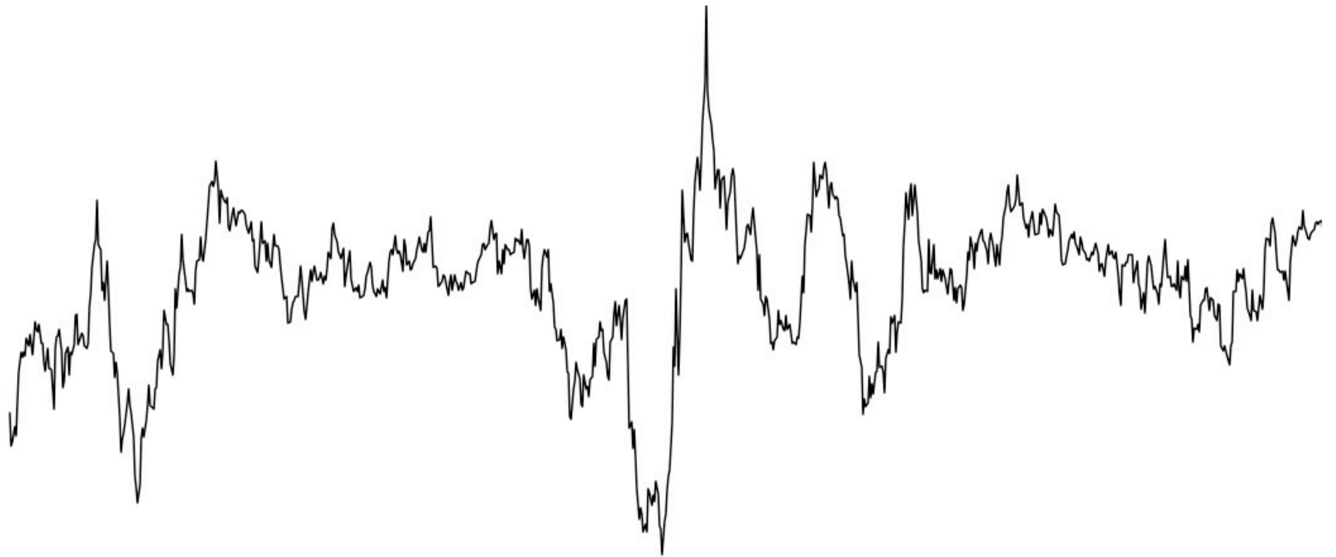

A BROKEN RECORD

First things first, I am GBP-based investor, which means that I need to think about both the value of currency and asset, when I dip my toe into US financial markets. With GBPUSD pushing 1.40 and the US 10y motoring bast 1.5%, I had to do something last week, and that something was to buy some duration in the US. I thought that I'd put that up front, because in what follows, I will sound like a broken record

It is now getting feisty in bond-land. The sell-off in US duration got rowdy last week, and is now starting to pull up bond yields in Europe. What's more, front-end curves are steepening too, which is to say that markets are now trying to bring forward rate hike expectations into market-relevant forecast horizons. As I have explained on these pages since the beginning of the year, investors and strategists are still debating whether this is all part of the plan—reflecting a desired increase in growth and inflation expectations—or whether it constitutes an undue tightening in financial conditions.

Market observers remain undecided, partly because policymakers can't seem to figure out where to draw the line either. Higher bond yields are good, so long as they don't become a constraint on the recovery via a tightening of financial conditions. In principle, there is nothing wrong with this position, though it also invites the situation we now find ourselves in. Put simply, yields will motor higher until something breaks, or until policymakers call it quits.

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CLAUSVISTESEN.COM, CLAUSVISTESEN@GMAIL.COM

Those of us either directly or indirectly involved in predicting or trading markets haven been trying to figure out when this is, since November. It is now clear that they're not terribly concerned about steeper yield curves, at least in the US, while last week's comments from ECB officials suggest that they're now worried, which is odd in light of the fact that the curve there isn't steepening that much.

In any case, the response from monetary policymakers to date, verbal or otherwise, challenges the expectation that yield curve control would be implemented early and aggressively if the long-end started to move. To be clear, this idea might be revived soon enough, but the fact that it hasn't yet has forced markets to contemplate the idea that reflation is real, and that bond markets will be allowed to reflect it.

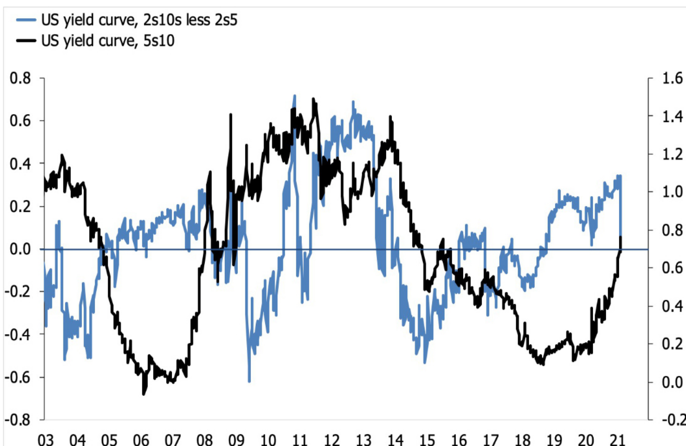
True to the title of this missive, I'll lead with an update of the same charts I led with in my last post. The first chart shows the development in the 5s10s and the 2s10s, less the 2s5s. In effect, a widening of these spreads suggest that markets are pricing in a stronger economy and higher inflation, *without* challenging the commitment to keep short-term interest rates pinned at the zero bound throughout the relevant near-term forecast horizon, no matter what inflation does. The unbreakable laws of fixed income trading prescribe that such a move eventually will sow the seeds of its own demise as the roll and carry draws in investors, eventually.

It's also possible, however, the sell-off in the long bond filters down the rate expectations structure, lifting short-term rates. As it turns out, this is now happening. Five-year yields popped by nearly 25bp last week, more than the 16bp increase in 10-year yields. In other words, the 5s10s flattened, and 2s5s steepened quite a bit more than 2s10s.

More generally on this topic, eurodollar contracts now imply a very aggressive lift-off by the Fed in 2023, and last week's price action even brought a significant sell-off in the Dec-22 contract. Such front-end steepening has even found its way to the Eurozone, which is probably why the ECB hit the tape last week. **For central banks tied to aggressive forward guidance on an 18-to-24 month basis, if not longer, such price action can't really be allowed for long.**

Cameron Crise highlights the dilemma by reminiscing about the Taper Tantrum in 2013, which occurred despite the fact that the Fed didn't hike until 2015. Put differently, this is the argument that you should buy the dip in bonds, of

fig. 01 / Is the front-end misbehaving? - **fig. 02** / EDZs suggest that it might be



all sizes. Hindsight is 20-20, though, and we shouldn't forget the second part of Cameron's argument; *this is the sort of pattern you get when there isn't much risk premium and the market thinks the Fed is behind the curve.* Personally, I think the sell-off in eurodollars is a buying-opportunity, but I am also wary that trying to pick bottoms in these kinds of instrument isn't easy.

Looking beyond bonds, I am also inclined to follow Cameron's lead that equities, and perhaps credit spreads, will tell us when central banks have had enough, if at all. *I can't help but wonder, though, if the bond market is somewhere in the back, totting up a hefty bill. If it ever presents it to the stock market, I guess that's when we can expect the Fed and others to reach for their wallets once again*.

In order to find out how close we might be to such a point, I tried to run a study seeing whether increases in fixed income volatility—measured by the MOVE index—combined with falling equity volatility—measured by the VIX—could be a bad omen for equities. After trying many permutations, I came up short.

What I did find, however, is that equity volatility seems cyclically elevated relative to fixed income volatility as the first chart below shows. This finding puts the publicized news that the MOVE index rose to a 12-month high in February into context. **Specifically, it suggests that bond market volatility will increase further, and that equity volatility fall further, not exactly what I have been arguing on these pages in recent months.**

Another simpler way to explain this is that bull market in equities, especially tech and growth stocks, has been much more resilient to the increase in bond yields than investors and strategists expected. I have recently shown charts to suggest why this might not last a lot longer, but it is fair to say that the recent steepening of the yield curve has not led to the gut-wrenching underperformance/decline in growth stocks that I had expected.

Incidentally, during the taper tantrum in 2013, this equity ratio didn't move much either, and the curve eventually flattened. More generally, this line of reasoning would seem to suggest long-term bond yields, and fixed income volatility, can rise quite a bit further before the stock market as a whole takes note. If that's true, those worrying about an imminent collapse in equities due to higher bond yields run the risk of sounding a bit like a broken record.

fig. 03 / How will this gap close, if at all? - **fig. 04** / And what about this one?