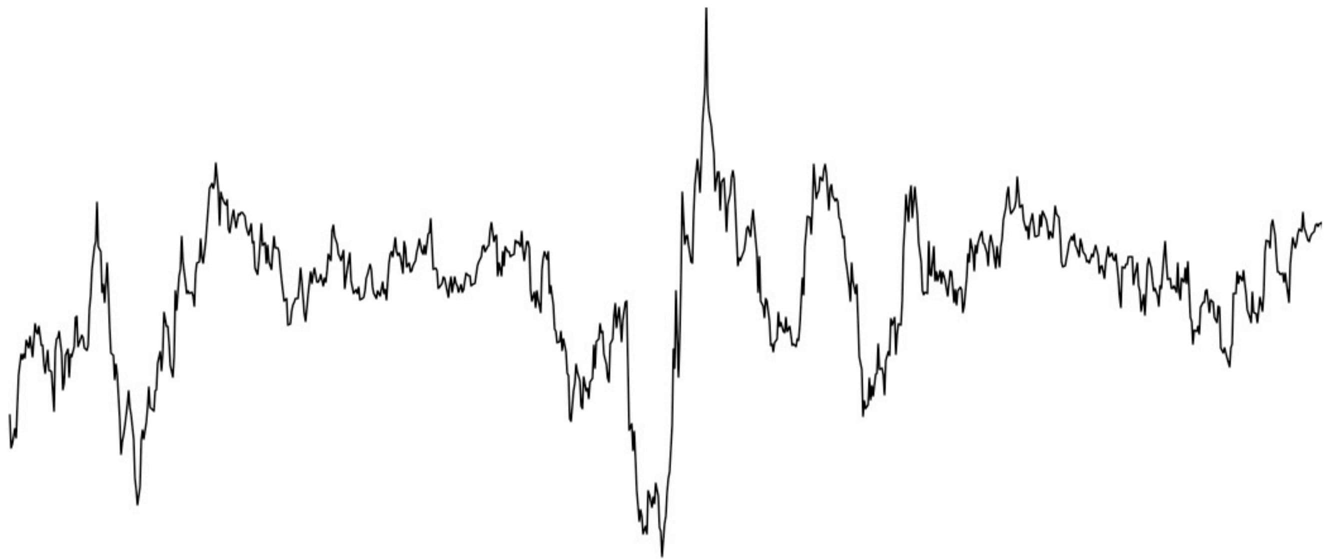
ALPHA SOURCES

NOVEMBER 8, 2021



MISTAKES HAPPEN

Sometimes in markets, everyone looks up the same price in the morning to get a feeling of where sentiment is. It's often one of the big ones; the S&P 500, the long bond, the price of oil, DXY, or gold, or even Bitcoin. Recently, everyone has been following the bloodbath in short-term interest rate markets as implied rates in one developed market after the other have gone haywire. Things have settled down slightly in the past week following the FOMC meeting, and the hilarious unch-BOE decision in the face of a near-certainty of a rate hike only a few weeks ago. I reckon implied rates will fall a bit further in the near term. The U.S. 2y, for instance, seems like it wants to go down before it'll try to snap back, implying that the violent decline in short-term interest rate futures—though not necessarily those for 2022—should ease a bit too. But it is difficult to escape the feeling that the genie is out the bottle. Expectations have shifted, and while central banks won't have to meet them as priced, they will have to deliver something.

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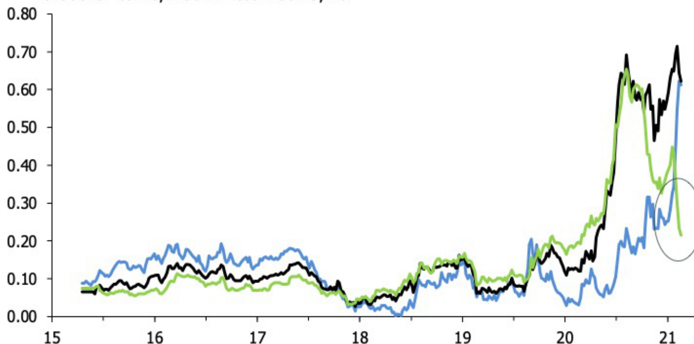
The implied path of short-term rates currently suggests that central banks—here the Fed and the ECB—are at risk of making a classic policy mistake. The first chart below shows that the 22-21 Eurodollar curve is still steepening sharply, in contrast to the 23-22 curve, which seems to be rolling over, and the sharp flattening of the 24-23 curve. The picture is similar in the euro area, even if the levels differ.

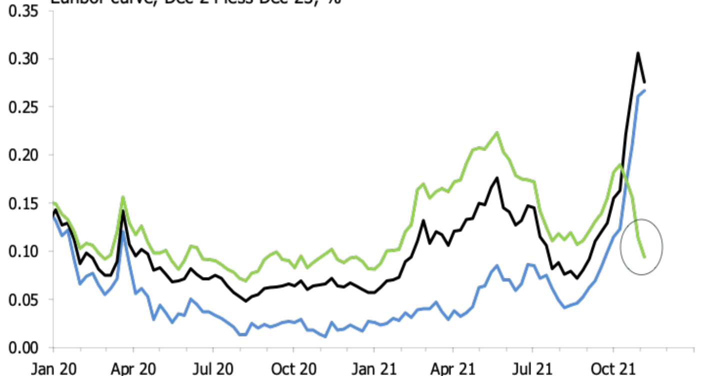
The flattening of the 24-23 curves is key to watch in the next few months. If it dips below zero, it would imply a sharp increase in rates next year and 2023, before a fall in 2024, presumably as the world's two largest central banks have to make a U-turn.

The idea that front-end rate markets are toying with the idea of a policy mistake isn't controversial. **It is a bit odd, however, is that markets assume the current crop of central banks are about to make one**. After all, these are same policymakers who have pledged their allegiance to running the economy hot and to stand side-by-side with their fiscal overlords, keeping nominal interest rates pinned to the floor to accommodate accelerating public investment. Why would these policymakers rush to stamp on the economic conditions they have promised to help conjure in the first place?

The answer, as it turns out, is the same it has always been; a sustained increase in inflation, which is now threatening to be lot less transitory than initially anticipated. Inflation is a lagging indicator—see more here—so it should be easy to predict, but it is fair to say that several factors currently make it more difficult than usual. The pandemic has bent the economy out of shape,

fig. 01 / Nasty, brutish and short at the Fed? - **fig. 02** / Short-lived lift-off in Europe?





and it is unclear when it will return to its old form, if at all. The laws of hysteresis prescribe that stimulus-driven demand, supply-side disruptions, soaring energy prices, and a reopening lift to core prices could drive more a sustained shift in inflation and wage pressures.

The two charts below show that global inflation—proxied by the PPI and survey-based price expectations—was still sizzling at the start of Q4. Inflation will cool, eventually, but policymakers and forecasters now must contend with the idea that it will be higher for longer.

It is logical that this would prompt central banks to dial down emergency stimulus—mainly QE—quickly. But it is not clear to me that short-term rates should follow higher so soon after, and as quickly as implied by front-end futures markets.

Leaving aside the staring contest between central banks and front-end rates, two questions impose themselves. Why aren't equities bothered by the shift in rate expectations? And where is the long bond going?

The answer to the first question is that they will, eventually. When they do, central banks will have to soldier on in their fight against inflation or fold like a cheap suit. **History indicate they will choose the latter.**

As for the long bond, it's tricky. If short rates are squeezed, the long bond should rally as the curve flattens, but if the post-pandemic trends of inflation and fiscal stimulus prove enduring, long rates really ought to increase, either on their own or in line with an advance in front-end rates. Investors need to keep an open mind, and remember; mistakes happen.

fig. 03 / Inflation is still rising... - **fig. 04** / ...in both services and goods