

# Who let the hawks out?

## Early surprises for the bond market in 2022



NEW YEAR 2022



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One week into the New Year and 10-year real yields in the U.S. have already moved up by 25bps. We normally don't comment on short term market volatility but this is highly unusual. The move can be traced to three drivers:



News that the Fed is already discussing earlier and faster rate hikes and balance sheet runoff. The December FOMC minutes say "Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate"



Expectations that the Omicron variant, which appears to be mild but broadly spread, will burn out before causing major harm to the economy.



New issuance so far in 2022 has been the heaviest since the first week of September 2021, adding new supply and selling pressure on existing bond positions. On January 4<sup>th</sup> alone, 13 borrowers issued over US\$23 billion of new corporate debt.

**Exhibit 1: U.S. 10-year yield**



Source: Bloomberg as of January 7, 2022

As the week progressed, the Fed dominated all else in the mind of bond investors.

Fed hike expectations in the market are now not far from the Fed dot plot. Almost 3.5 hikes are priced in by the end of 2022 vs the Fed's dot plot of three hikes, with the first hike fully priced for May. Note that the market is pricing in an almost 80% chance of the first hike coming as soon as March, which would have been considered absurd just a few months ago (Exhibit 2). The Bank of Canada (BoC) has been ahead of the Fed in removing stimulus and not much has changed in recent days as news was purely on the U.S. side. BoC expectations are more aggressive with five hikes priced in by end of 2022, 50% probability of a hike on January 26, and one hike fully priced in by March 2.

In the last quarter of 2021, we tended to be below market consensus for rate hike expectations, which aligns with our mostly below consensus yield forecasts as well. Our expectations were for one hike in 2022 slanted towards the end of the year.

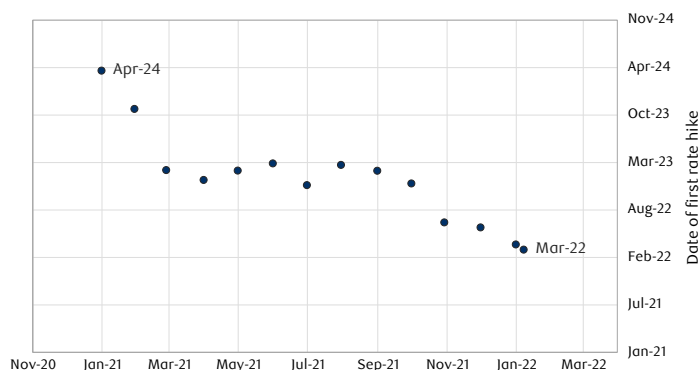
However, the recent release of Fed minutes from the December 15 meeting made us (and the market) re-evaluate the Fed expectations. While the market added to the number of hikes, we are more inclined to change their timing of the single hike to the first half of 2022. Fed minutes surprised

by introducing the prospect of quantitative tightening (QT) taking place in 2022. That's in addition to ending quantitative easing (QE), and hiking short term rates, which implies a much faster removal of extraordinary monetary stimulus than in the 2014-2019 precedent. In that episode, there was a gap of three years between the end of QE and the beginning of QT (Exhibit 3).

I believe the Fed pivoted to take advantage of a window of opportunity to remove some easing while they can. Inflation is way higher than they had anticipated, growth remains strong, and while there is a lot of political pressure to act on inflation, waiting for equitable and full employment seems to be a lower priority. Gains in the labour market have been powerful and accompanied by higher earnings. The unemployment rate dropping to 3.9% happened much sooner than expected. Moreover, the perception is that employment would have been even higher had it not been for staff shortages. Reviewing the line of questioning in recent Congress hearings of Jay Powell and Janet Yellen shows that inflation rather than employment is top of mind for Washington power brokers.

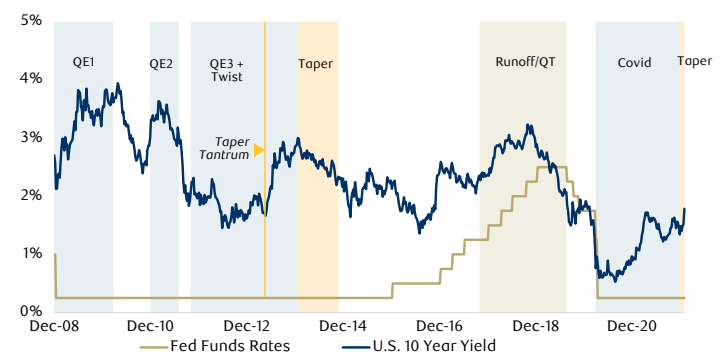
The addition of QT to the mix adds to uncertainty, which leads us to increase our estimate of term premium and our year-end forecast for 10 year U.S. Treasuries from 1.75% to 2.0%. Forward pricing is just shy of that level.

**Exhibit 2: Fed lift-off expectations have been brought forward by two years**



Source: Morgan Stanley, as of January 7, 2022

**Exhibit 3: Monetary policy and yields – the long pause between Taper and QT not to be repeated this time?**



Source: Bloomberg as of January 7, 2022. Time periods for each event from Deutsche Bank

While we make this cyclical adjustment to our forecast, we keep in mind structural factors that are expected to exert downward pressure on yields. Among them: demographics, high government debt loads, wealth and income inequality, and of course, significant presence in the market of bond buyers who are not price sensitive.

These bond market players are not irrational, their demand is driven by policy and regulatory reasons:

- Central banks for QE and macro management
- Central banks for reserves and Balance of Payment management
- Pension and insurance companies for liability management
- Banks for regulatory reasons
- Balanced funds and risk parity investors for safety

Most of these purchase needs have been exacerbated by the pandemic. For example, strong gains in equities led to higher funded status for pension funds, resulting in more demand for immunization of their liabilities via bond purchases. Another potentially exacerbating factor comes from the ongoing and lasting damage to growth potential from the pandemic itself, which historically is followed by lower real rates. At the risk of arguing “this time is different” unwisely, I would put lower weight on that last argument as the accelerated shift to work-from-home (WFH), more intense use of technology, incentives to increase productivity through capex may neutralize this historic pattern.

The reason we refer to the first half of 2022 as the Fed’s window of opportunity is that inflation is very likely peaking early in the year, if the peak is not already behind us. With Omicron potentially extending the gumming up of supply chains, the market is in a state of inflation panic. Yet inventories are being aggressively built, and many delayed items being shipped are more likely to be discounted than sold at a premium. Labour force participation is increasing and will likely continue to do so by WFH enabling the addition of women and people with disabilities, as well as youth attracted by higher wages for entry level jobs. Finally, capex spending has been increasing and should add to the recent uptick in productivity. If all these factors added to base effects translate into lower inflation readings as expected, the Fed’s window of opportunity for pulling back

monetary easing will be shutting down as the summer turns. The moderating growth and falling inflation scenario should be bond friendly as investors start thinking about 2023.

We should not consider U.S. policy and demand for US Treasuries in isolation. Outside of the U.S., other central banks such as the European Central Bank (ECB) and Bank of Japan (BOJ), are still easing. The ECB need to get to their 2.0% inflation target, yet even with the current policy set up they don’t expect to achieve that within their forecast horizon. Rate hikes are not signaled for this year, although the market priced in one for December. European inflation is mostly driven by energy prices and the central bank tends to look through them. Other non-domestic considerations for the global bond market include geopolitical risk of Russia’s attack on Ukraine, and the People’s Bank of China starting to ease for the first time since April 2020.

Bond yields look through daily headlines, data releases and cyclical fluctuations, and eventually are directed by the long-term structural drivers we discussed earlier. Structural multi-decade declines in real rates, reinforced by post-pandemic lingering effects, and more accelerated shrinking of the Fed’s balance sheet may result in fewer hikes needed to achieve the same tightening effect as in previous cycles. With that in mind, we are eyeing lower long-term neutral rates (terminal rates), and think about the next 12 months in the context of three major scenarios for yield developments:

**Base case:** Fed will end QE first, hike once in the first half of the year, at most twice this year, which is much less than what is priced in. The current pricing/curve shape is similar to what we have seen in previous cycles when hikes were already well underway. QT starts in the second half at a slow pace, perhaps focused on shorter maturities. The terminal rate for fed funds assumed at 2%, vs. current market pricing of about 1.5%. U.S. 10 year Treasury yields will end the year at 2.0% as the term premium goes up.

**Tail risk I:** Inflation doesn’t come down in 2022, and the Fed is seen as slow moving behind the curve, hiking only towards the end of the year, QT late this year or shifted to 2023. This results in a rapid curve steepening, terminal fed funds rate assumed to shift to 2.5%, U.S. 10 year Treasury yields rise to 2.5% within 12 months.

**Tail risk II:** Fed ends QE, starts a hiking cycle and QT almost immediately after, both in the first half of the year. Growth surprises stronger in the first half of 2022. The yield curve moves up in a bearish flattener. Terminal rate is assumed to be 1.5%, yields first up on higher term premium and real rates in 2022, but crashing in 2023.

As 2022 starts with a bang I note that over 20 years of market watching taught me to not entirely trust the moves of the first week of the year. That mistrust is needed more than ever this year given the communication risks faced by central banks. No matter what scenario transpires, one thing is as certain as certain can be in markets – that the era of ultra-loose, almost absurdly stimulative monetary policy is coming to an

end. Markets will be impacted, not just bonds, all markets. The timing is uncertain, and the execution risk for the Fed is very high. They are very aware of it. They have prepared some tools to alleviate at least some short-term strains in financial markets. Back in July 2021 the Fed introduced the Standing Repo Facility, which can provide as much as \$500 billion of cash overnight to the banking system. Another facility offers dollars to central banks around the world. The New York Fed can accommodate short term liquidity demand through additional domestic repurchase agreements. Nothing like this withdrawal has ever been done before so we can bet that investors' tolerance for uncertainty, ability to stick to the plan and acceptance of volatility will be tested.

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