

Fixed Income Research & Macro Strategy (FIRMS) – 14<sup>th</sup> May 2021

## *US markets playing along to Fed tune...for now*

Treasury Secretary Yellen's comments ten days ago were merely a temporary distraction. Perhaps more surprisingly, at first glance, the release on Wednesday of a much larger-than-expected increase in US CPI-inflation in April has not had much "sticking power".

Core CPI-inflation almost doubled to 3.0% yoy (the high since December 1995) and as a result the Federal Reserve's "real core" policy rate fell to a multi-decade low of -2.8%.

The range-bound 10-year Treasury yield subsequently closed 7bp higher at a 5-week high of 1.69%. The S&P 500 sell-off (-2.1%) and Dollar NEER rally (+0.6%) recorded on 12<sup>th</sup> May were both the largest since 25<sup>th</sup> February.

However this spike in volatility was modest in the greater scheme of things. More poignantly, these far from dramatic moves have been largely reversed in the past 48 hours.

The Dollar NEER is back to within striking distance of the 3-year low recorded on 10<sup>th</sup> May, in line with our bearish Dollar view. Markets are still only pricing in 15bp of rate hikes by end-2022, versus pricing of 12bp of hikes pre Wednesday's release of US CPI-inflation data.

Markets, rightly in our view, are still not fully convinced that the Federal Reserve will signal, let alone deliver, a tightening of US monetary policy in coming months.

The Federal Reserve after all has form, having kept its "real core" policy rate firmly in the red in 2012-2015 (it averaged -1.7%) despite annualised GDP growth averaging a decent 2.2% qoq. By comparison the Federal Reserve's "real core" policy rate averaged -1.4% between Q2 2020 and Q1 2021 despite GDP growth having averaged only 1.1% qoq.

At the very least markets still seemingly have appetite to be long US equities and short Dollars. While not insensitive to valuations and the risk posed by further upside inflation surprises we remain bearish the Dollar near-term.

Finally, while much of the debate about Covid-19, vaccination, the re-opening of economies and the bogeyman of inflation has centred on what will happen in 2021, more attention needs to be paid to 2022, in our view.

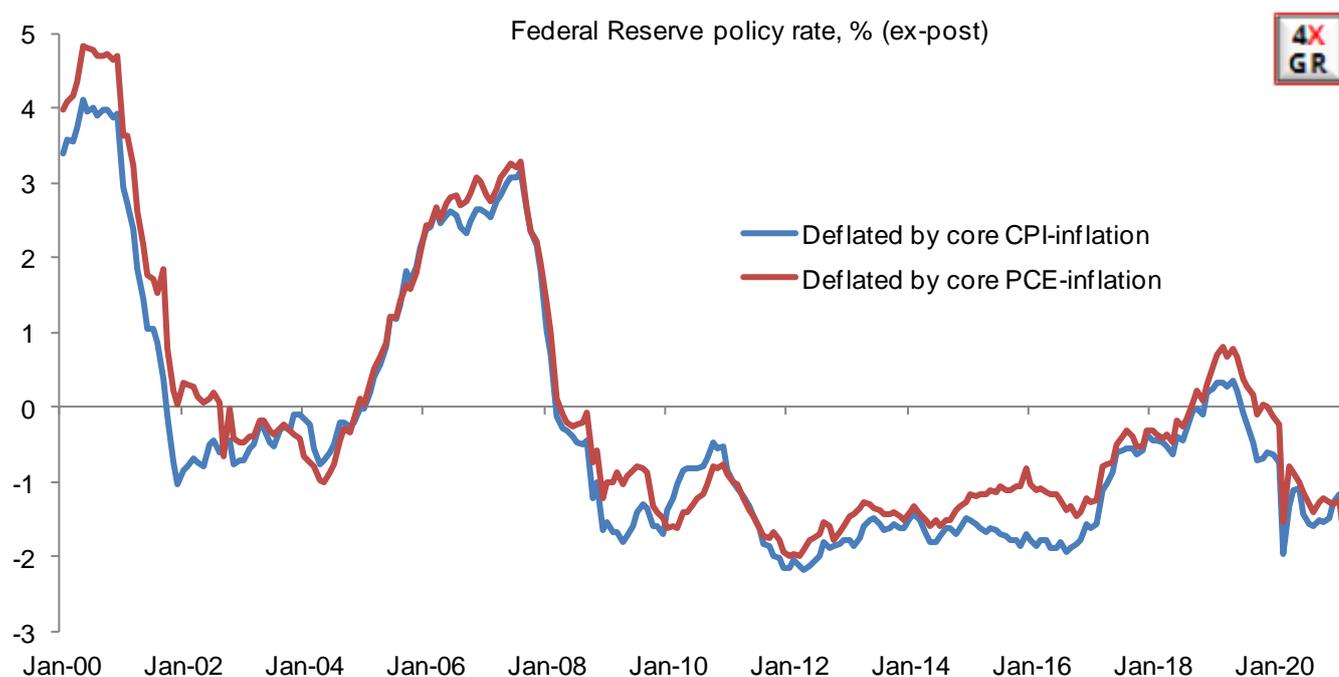
## “Yellen yo-yo” gives way to upward surprise in US CPI-inflation

We noted a fortnight ago that volatility and directionality in US asset prices – namely the Dollar, the benchmark 10-year Treasury yield and S&P 500 – remained subdued and that at some point something had to give (see [Something has got to give](#), 30<sup>th</sup> April 2021). And indeed on 4<sup>th</sup> May US markets briefly came alive after US Treasury Secretary and former Federal Reserve Chairperson Janet Yellen was quoted as having said that the Federal Reserve’s policy rate may have to rise in order to stop the US economy from over-heating. But price action in US financial markets reversed and subsided after Yellen quickly clarified (backtracked?) that she was not forecasting US rates to rise or that they should rise.

This “Yellen yo-yo” move was not totally surprising – after all her comment was (deliberately?) vague on timings and ultimately not particularly contentious. Perhaps more surprisingly, at least at first glance, the release on Wednesday of a much larger-than-expected increase in both core and headline US CPI-inflation in April has not had much “sticking power”. US headline CPI-inflation rose to 4.2% yoy in April – its highest level since October 2008 and well above the consensus forecast of 3.6% yoy – from 2.6% yoy in March. Perhaps more importantly core CPI-inflation, which excludes more volatile food and energy prices, almost doubled in April to 3.0% yoy (the high since December 1995) from 1.6% yoy in March. Again this was well above the consensus forecast of 2.3% yoy.

As a result the Federal Reserve’s “real core” policy rate – the nominal policy rate deflated by core CPI-inflation (ex-post) – fell to a multi-decade low of -2.8% according to our estimates (see Figure 1).

Figure 1: Federal Reserve’s “real” policy rate deep in the red but is US interest rate policy excessively loose?



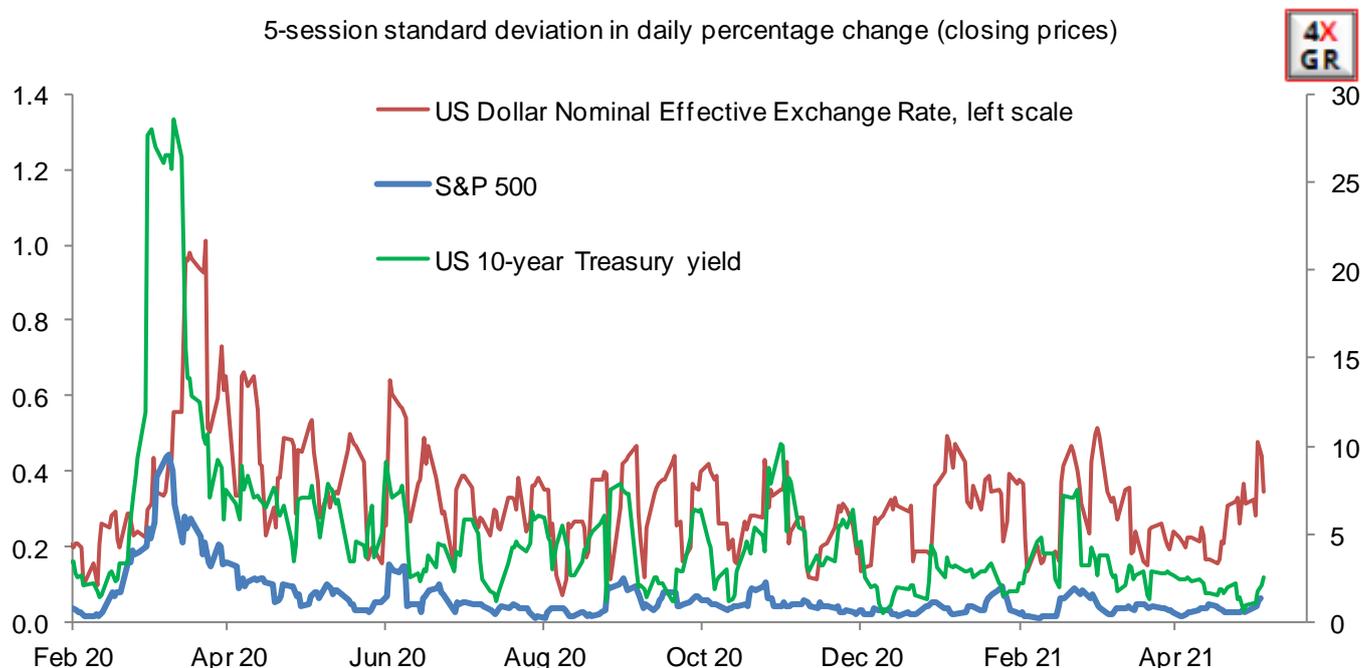
Source: 4X Global Research, Federal Reserve, US Bureau of Economic Analysis, US Bureau of Labour Statistics

Note: The [BEA](#) is due to release PCE-inflation data for April 2021 on 28<sup>th</sup> May

## Moderately higher volatility but price action in US markets quickly reversed

The 10-year Treasury yield, which had been range-bound in recent weeks, closed 7bp higher at a 5-week high of 1.69% while the S&P 500, which had already shed 1.9% in the previous two sessions, ended the session down 2.1%. The “safe-haven” Dollar was perhaps unsurprisingly the main beneficiary. The Dollar Nominal Effective Exchange Rate (NEER), which has consistently been negatively correlated to the S&P 500 (and more broadly to “riskier” assets) in the past 14 months, rebounded 0.6% on 12<sup>th</sup> May, according to our estimates. The S&P 500 sell-off and Dollar rally recorded on 12<sup>th</sup> May were both the largest since 25<sup>th</sup> February.

Figure 2: Volatility in US asset prices higher in wake of US CPI-inflation surprise but everything is relative



Source: 4X Global Research, Federal Reserve, investing.com

Note: Last data point is 13<sup>th</sup> May 2021 for S&P 500 and 14<sup>th</sup> May (13.00 London time) for US Treasury yield and US Dollar.

However, as Figure 2 shows, this spike in volatility was modest in the greater scheme of things. Even more poignantly, these (far from dramatic) moves have been largely reversed in the past 48 hours. The 10-year Treasury yield dropped 3bp, the S&P 500 (+1.2%) recouped half of the previous session’s loss and the Dollar NEER weakened 0.2% yesterday. As of 13.00 London time today this reversal had extended, with 10-year yields down a further 2bp to around 1.64% – well within their 9-week range of 1.52-1.74% (using closing prices). Meanwhile the Dollar NEER had weakened a further 0.3% and was within striking distance of the 3-year low recorded on 10<sup>th</sup> May (see Figure 3). This is aligned with our bearish Dollar forecast which we re-iterated on 19<sup>th</sup> April (see [Dollar and the three bears](#)).

Figure 3: “Safe-haven” US Dollar once again within striking distance of 3-year low



Source: 4X Global Research, Federal Reserve, investing.com

### Fed has form when it comes to keeping stimulative real interest rate policy

Analysts are seemingly convinced, arguably for good reasons, that US CPI-inflation will continue to rise in coming months, and not just because of unfavourable base effects. Price action on Wednesday underscores markets' sensitivity (although far from acute) to upside surprises in US CPI-inflation data and concerns that rising US inflation will at some point undermine the Federal Reserve's average-inflation targeting model and challenge its dovish outlook for US monetary policy.

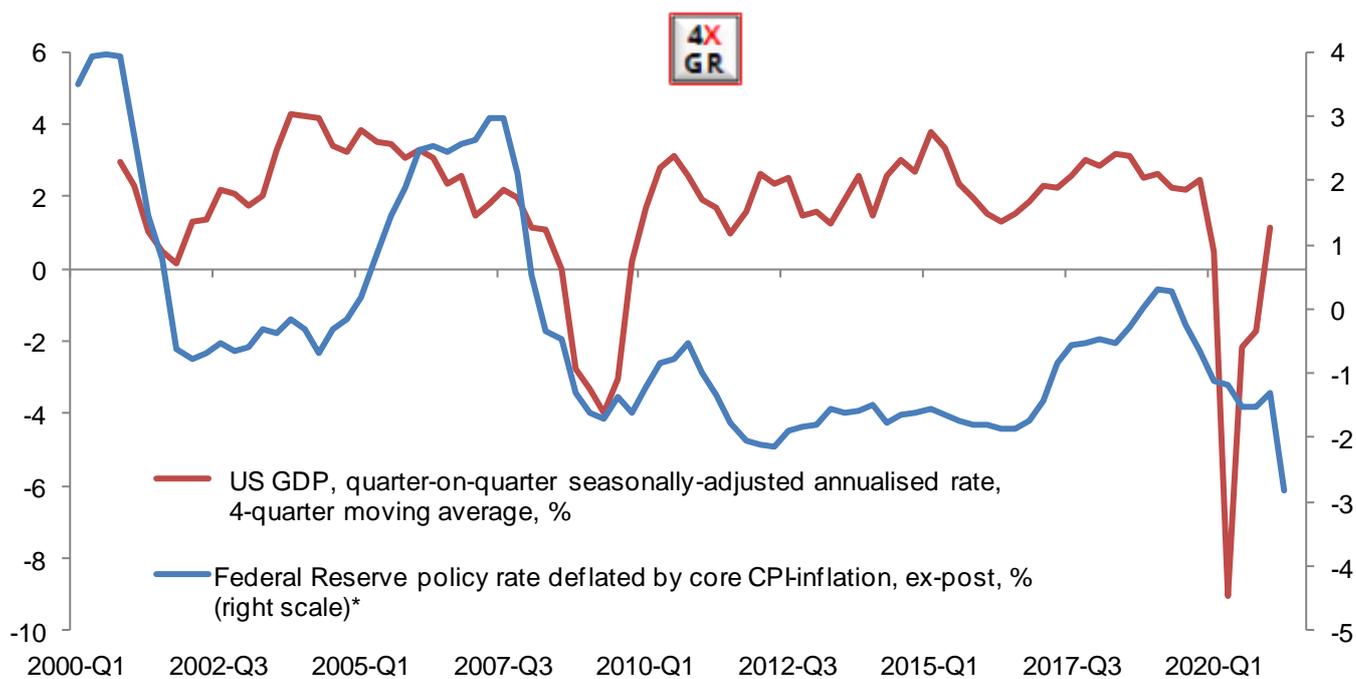
However, price action in the past 48 hours suggests that markets, rightly in our view, are still not fully convinced that the Federal Reserve will signal, let alone deliver, a tightening of US monetary policy in coming months. The OIS market is still only pricing in 15bp of rate hikes by end-2022 (or a 60% probability of one 25bp rate hike), versus pricing of 12bp of hikes pre Wednesday's release of US inflation data.

The Fed after all has form. The Federal Reserve kept its “real core” policy rate firmly in negative territory for four years between 2012 and 2015 (it averaged -1.7%) despite annualised GDP growth averaging a decent 2.2% quarter-on-quarter (see Figure 4). It only started hiking its policy rate (and very slowly) in December 2015 and only started hiking its policy rate more forcefully in December 2016 when it was clear that US GDP growth was well anchored and picking up (it averaged 2.7% qoq in 2017-2018).

By comparison the Federal Reserve's “real core” policy rate collapsed to -2.8% in April (from -1.2% in February), as noted above, but averaged -1.4% in the previous 12 months despite GDP growth having averaged only 1.1% qoq between Q2 2020 and Q1 2021. In crude terms the gap between the red and blue

lines in Figures is not particularly large by historical standards. The Federal Reserve could argue (as it has done implicitly) that interest rate policy has not been excessively loose in the past year or so and therefore can justifiably remain stimulative for the foreseeable future.

Figure 4: The gap between Fed's real policy rate and US GDP growth was wider in 2012-2015 than in Q1 2021



Source: 4X Global Research, Federal Reserve, US Bureau of Labour Statistics

Note: Quarterly data. \* Last data point is for April 2021

At the very least we would argue that market participants still have appetite to be long US equities (and thus to “buy the dips”) and short the US Dollar (and thus “fade” Dollar rallies). With this in mind we remain bearish the US Dollar near-term.

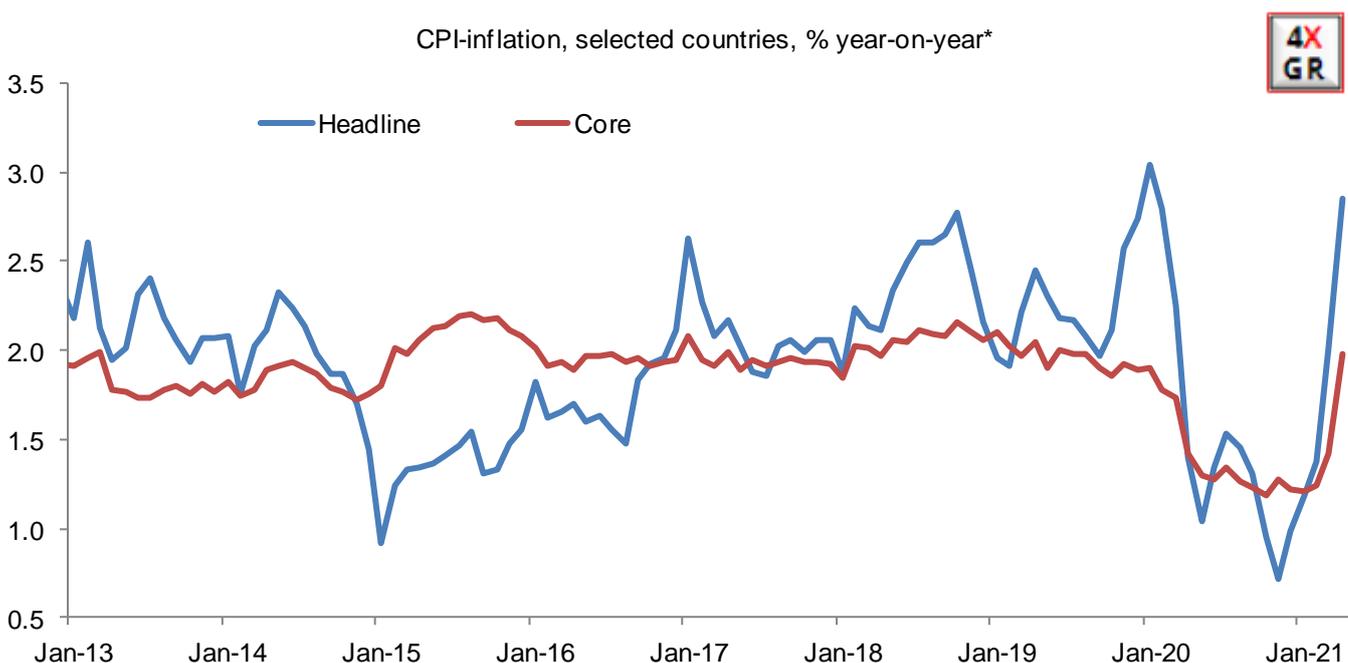
We are nevertheless not insensitive to valuations and the fact that, as noted above, the Dollar NEER is currently trading near a 3-year low. Nor do we ignore the possibility that further upward surprises in US inflation measures could eventually lead to markets concluding with greater certainty that the Federal Reserve will have no choice but to veer off script and tighten monetary policy sooner than the majority of FOMC members have so far indicated, both verbally and in the most recent “dot-chart” (see [EM currencies: Central bank friends and foes](#), 19<sup>th</sup> March 2021). With this in mind the [BEA's](#) scheduled release of PCE-inflation data on 28<sup>th</sup> May will be another important hurdle for markets clear, particularly as core PCE-inflation is the Federal Reserve's preferred measured of inflation.

## What about 2022?

**Much of the debate about Covid-19, vaccination, the re-opening of economies and the bogeyman of inflation has centred on what will happen in the remainder of 2021. More attention needs to be paid to 2022, in our view.**

Global core and in particular headline CPI-inflation rose in March and accelerated further in April based on partial data for economies accounting for about of 75% of world GDP according to our calculations (see Figure 5). The overwhelming consensus forecast, which we broadly agree with, is that global CPI-inflation will continue to rise in next six months or so due to a wide number of supply and demand-side factors beyond unfavourable base effects (low CPI-inflation in 2020). These include the lagged effect of higher and still rising international raw material and commodity prices, freight and packaging costs and factory input and output prices (exacerbated by supply constraints/bottlenecks and re-stocking) and pent-up demand being unleashed in most developed nations and some emerging market economies.

**Figure 5: “Global” CPI-inflation surged in April, with core already back in line with pre-pandemic average**



*Source: 4X Global Research, IMF, national statistics offices and central banks*

*Note: GDP-weighted baskets of CPI-inflation in major economies which have so far released April 2021 data. These are Brazil (only headline), China, Chile, Colombia, Eurozone, Indonesia, Korea, Mexico, Norway (only headline), Philippines, Russia, Switzerland, Taiwan, Thailand, Turkey and United States.*

However, most central banks have made clear that, while not ignorant of this likely trend, they have a far longer-time horizon than most speculative investors. So the question is what to expect beyond 2021 and specifically whether global CPI-inflation will continue to rise, flat-line at a relatively high level or start coming down in 2022.

We would argue the latter and not just because of more favourable base effects (i.e. high CPI-inflation in 2021). First, the "long-commodity" play may start running into serious valuation issues. Second, stocks of raw materials and commodities are likely to have been at least partially replenished. Third, higher consumer prices will attract new suppliers to come on line. Finally, and perhaps most importantly, much of this famed "pent-up demand" will have been spent by end-2021 because most developed and some EM economies will have re-opened for business by then. Therefore, the marginal impact of consumption on consumer prices (demand-pull inflation) will be weaker in 2022 in our view, even without taking into account the probability that tax rates will rise in a number of developed economies, including the United Kingdom.

The United States may still be "running hot" in 2022 because of loose US fiscal policy playing out over years rather than months and some EM economies may start benefiting from faster vaccine roll-outs and a normalisation in economic growth. However, we do not think it's a foregone conclusion that global economic growth and CPI-inflation will be spectacular in 2022.

That does not mean that global central bank interest rates do not need to or will not rise in the next 18 months. They do and probably will. Central banks in Brazil, Russia and Turkey have already hiked their policy rates in the past two months. However, central banks, particularly in the developed world, have a bit of time on their hands as long as they can convince markets, as the Federal Reserve, European Central Bank and Bank of England have successfully done so far, that monetary policy does not need to be tightened aggressively near-term.



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