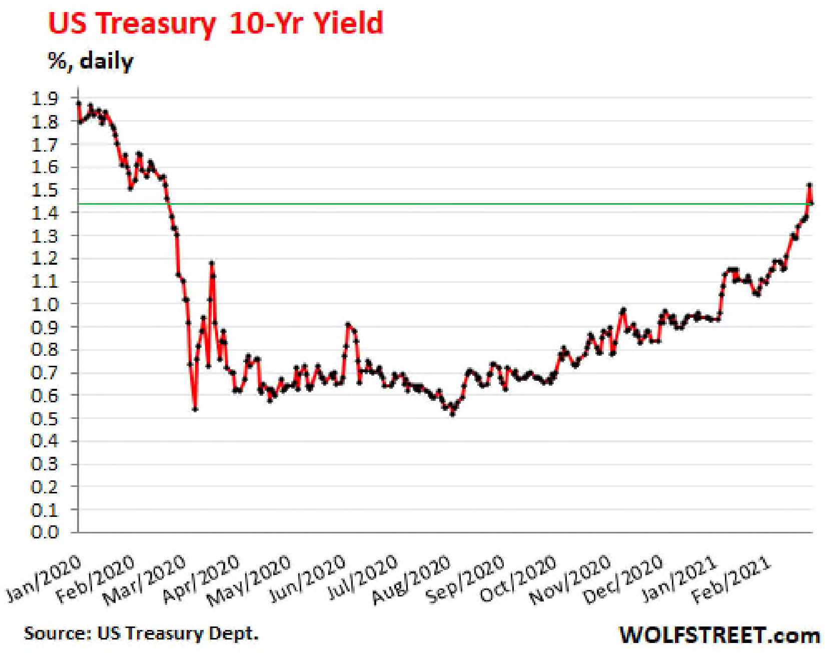
THE National Investor

Feb. 28, 2021 *You can get information anywhere. Here, you get KNOWLEDGE*. MARKET COMMENTS

THE FED'S CALCULATED RISK: BUT JUST HOW HIGH WILL THEY LET RATES GO?

The past week saw more volatility—with a downside bias—to the stock market than we have seen in a while. **The proximate cause was one of the sharpest rises in long-term Treasury yields than we have seen in quite a long time; *and more so the appearance that, for now, the Federal Reserve will at least tolerate (if not encourage) this move*.**



Source: US Treasury Dept.

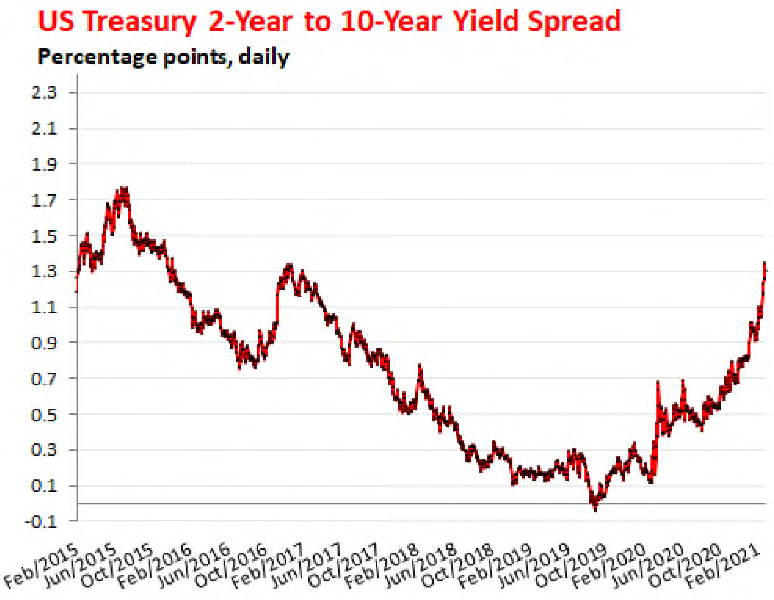
The *way* in which the spike in yields went parabolic for a while this week was understandably unnerving. That is especially the case when—as I pointed out prior—the 1.4% area on the bellwether 10-year Treasury Note's yield was one to watch as a likely stopping point in the rise. Though it *ended* the week in that neighborhood, it was not before the bond rout caused the 10-year's yield to tag 1.6%. *By all appearances, we're not done with this move yet*.

Of course, *any* rise in yields that leads to *any* significant declines in juiced-up risk assets is unnerving to the spoiled brats on Wall Street used to the Fed *always* guaranteeing them profits no matter what they do. Yet as my friend Wolf Richter points out this weekend (see https://wolfstreet.com/2021/02/27/treasury-market-had-a-cow-mortgage-rates-jumped-wall-street-crybabies-clamored-for-help-but-the-fed-smiled-satisfied-upon-its-creation/) in seconding the notion that I shared earlier this week**, the Fed "approves" of the unfolding outcome in the markets—so far, anyway—that they hope *by design and intent* will take away some of the *worst* froth and silly excesses of the recent past (AND do *no worse* than that.)**

Richter quotes Chairman Powell and other Fed officials as singing from pretty much the same song sheet: **generally speaking, the rise in yields is "healthy."** It shows that investors are gaining more confidence that the economy will continue moving back toward some semblance of "normal." By that view, it makes perfect sense that Treasury securities would be sold off in favor of just about everything else: be that stocks, industrial metals, oil, green energy plays, agricultural commodities, housing, etc. *After all, though the rise of the last several months has been rather abrupt considering where we started, long-term yields are merely back to about where they were at the Plannedemic's beginning*.

The greatest "benefit" the Fed has seen in the rise in long-term yields is in the steepened yield curve. This dynamic underscores the contention that people are feeling better about life these days; and that there is now a greater profit incentive for lenders to lend.

And as Powell repeated ad nauseum in this past week's Humphrey-Hawkins testimony to the respective Senate and House committees charged with "overseeing" (Har har!) the central bank, the rise in yields won't get *too* out of hand because inflation is still so tame. **Understandably, some *don't believe him*: one of the risks in a few of the old-school bond market vigilantes returning from a LONG exile, if not from the dead.** But to hear Cargo Plane Jay tell it, we're still a long ways from "inflation" hitting the Fed's target (the implication being, based on this last week, that we WILL at least see some "jawboning" from the Fed if the rise in yields get too out of hand.)



Source: US Treasury Dept. WOLFSTREET.com

BUT THE BOND VIGILANTES *DO* SMELL BLOOD IN THE WATER

"I'll start selling bonds if you do not take steps to reel in inflation."

To be sure, at least some of the selling in Treasuries (and in gold, as I have continued to explain) is due to investors' overall "risk on" attitudes; their view *to some extent* that we do have an extended period in front of us where the economy gets healthier, etc. **However, by definition—despite Powell and other Fed heads dismissing the potential magnitude of this—that *does* mean in the end that we *will* have more consumer/producer price inflation than the central bank is presently willing to acknowledge or admit.** By no means does that imply we are on our way back to 1970s-style price rises; indeed, such a thing today is *a mathematical impossibility*. But even modest price inflation suggests that long-suppressed Treasury yields *remain* too low, even after this last week.

This is why—in recent days—we have seen a few of the "bond market vigilantes" of old returning from their absences. Those my age and older who have been around the financial markets long enough (the 42nd year for Yours truly now) vividly recall the episode four decades ago when investors across the board shunned Uncle Sam's IOU's due to their lack of confidence in the dollar and the then-unique factor of America running its national finances into the ground. Alternately selling or *just refusing to buy* Treasury paper at auction caused market interest rates to *soar*. Eventually, the Fed was forced to respond by aggressively raising *short-term* interest rates and shoring up the dollar, etc.

While that extreme episode which peaked in the early 1980s during the first part of Paul Volcker's Fed chairmanship as an inflation *hawk* has not been matched since, we have seen a few instances here and there of its like. **Most noteworthy—for those who have forgotten—it was Japan as bond market vigilante which almost single-handedly caused the stock market crash of 1987.** In those days, Japan for various reasons was the main buyer of U.S. Treasury securities; *and notably, before the Federal Reserve figured out that it was going to have to itself become the buyer of last resort someday*. Unhappy at the time with both the declining dollar and America's fiscal deficits, Japan essentially boycotted auctions of U.S. debt until interest rates rose substantially; long-term yields were in the neighborhood of 6% at the beginning of 1987 but soared to double digits by late summer (as the stock market peaked.)

The rest, as they say, is history.

Ominously, this past week saw a *horrid* auction of seven-year Treasuries. Notably, the weak demand and much higher yields required to sell this paper especially spooked the markets and *directly* caused that brief pop to 1.6% in the 10-year. It seems virtually a given that Treasury auctions to come *at least for a while* may see the same dynamics play out.

THE FED'S "GAME PLAN"—SUCH AS IT IS—AND *THE RISKS*

While the Reserve Bank of Australia has just tried (*and failed*) to rein in bond vigilantes there…and the E.C.B.'s Christine Lagarde has fired a couple *verbal* warning shots across their bows…The Fed is content for the time being to tolerate a few bond vigilantes seemingly rising from the dead. It is wagering in doing so that these zombies can be put right back into their graves as easily and quickly as they have been allowed to rise. *We shall see*.

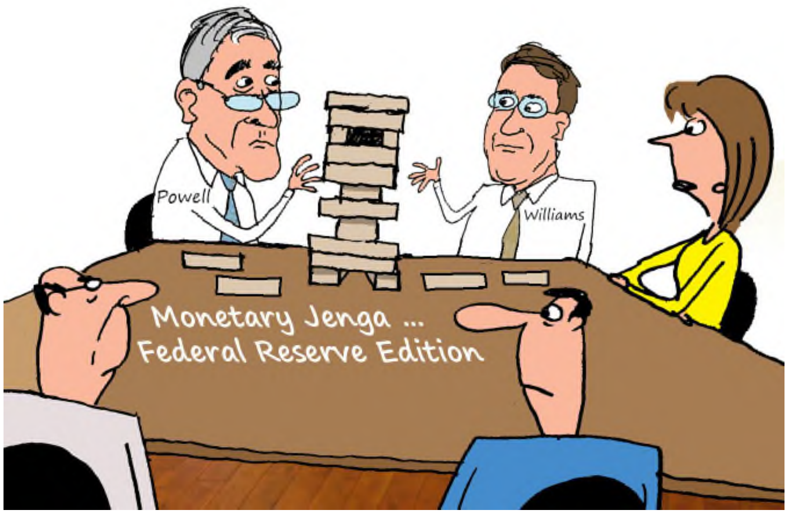
BOND VIGILANTE APOCALYPSE

It needs to be understood here that—for all the nonsensical talk from some of "price suppression" when it comes to precious metals that I am regularly charged with calling out—**it has been the suppression *of the price of money/credit* that has been THE biggest dynamic in financial markets for quite a long time now**. By all of them keeping borrowing costs artificially low, central banks have created ever-growing financial bubbles elsewhere. Virtually all traditional principles of risk, price discovery and the rest have been pushed to the side. The bankers' "Everyone gets a trophy" system when it comes to credit has actually served to make the organic economy ever weaker and more vulnerable to shock. Yet—as I have explained many a time and will again in the near future— there has simply been no other alternative to keep all of the *skyscrapers* of cards from imploding.

Of all things—again, *for the time being*—the Fed has determined that the potential rewards outweigh the risks in allowing markets themselves to work at least somewhat. Chairman Powell himself—actually being a market-oriented person, as opposed to the *academic* nitwits that he has succeeded—is smart enough to understand that, YES, there is some froth in the markets. And the risk that Powell and Company are taking is that they can give *a little* room to the bond vigilantes; so long as 1. The markets buy, more than not, the idea that inflation *really will* stay tame, 2. A *further* decline in value/rising yield for Treasuries continues to be seen (again, by *most*) as beneficial and 3. ***Nothing "breaks***."

The last of those harkens back—as you may recall—to when Powell began his tenure at the beginning of 2018 determined to try to "normalize" monetary policy. As you will also remember (I have reminded you enough, especially recently!) Powell took this course for a while as he correctly explained to markets that it was *the Fed itself* previously that was responsible for the last two major economic debacles. By allowing bubbles and financial imbalances to grow almost unchecked because of its E-Z money policy and all, those bubbles inevitably had to burst; and take the economy with them. Powell said he would avoid that; and for the better part of a year he did (for more on this time and as a refresher, check out https://nationalinvestor.com/2009/a-year-in-the-life-of-fed-chair-jerome-powell/.

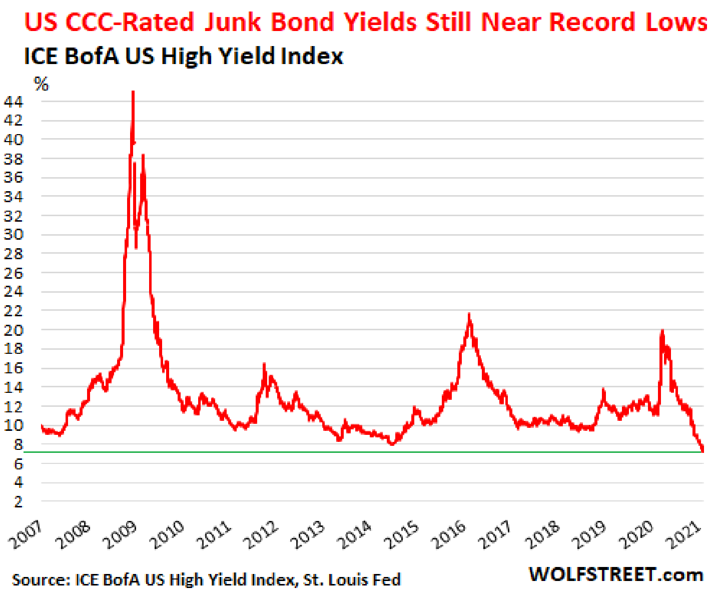
Given just how much markets and the economy both, however, had become ever more dependent on all-but-free-credit *just to continue to exist*, this was a risky move. As bond guru Jeffrey Gundlach explained it back then, Fed policy could be boiled down to "We will raise rates and 'normalize' until we break something." I likened it to a game of Jenga; and likewise questioned whether the Fed would have either the wisdom or the luck to know when to stop pulling out sticks. Eventually, of course, a second major market rebellion in 2018 at the end of that year prompted Powell to raise that white flag in front of the Eccles Building.



The Fed thinks/hopes it can now "ease" a bit of froth out of the markets by allowing a few resurrected bond vigilantes to help push long-term rates higher. **The problem now, though, is that it is those returned/resurrected vigilantes that now have the ability to pull out a few of those Jenga sticks in this game**. At the next crummy Treasury auction…the next "hot" PPI (or CPI?) number…will they pull out too many and cause such a spike higher in yields that risk assets broadly get hammered *more* than the Fed intends? We'll see.

Some (besides me) are already warning that this past week was a bad omen that the Fed might "lose control" of things for a spell, at least. The venerable old U.B.S. Financial Services veteran Art Cashin, as I, remembers the late 70's-early 80's. He suggested at week's end that there will be more pain to come for stocks, especially, as Powell lets the "Walking Dead" bond vigilantes have a little fun for a while; see https://www.cnbc.com/2021/02/26/art-cashin-on-stock-market-swings-and-fed-control-on-bond-market.html.

So far, of course, no major damage has happened; and the Fed (properly, for a change) is *not* of a mind to jump and respond to the spoiled crybabies who think that now it should intervene anew to stop the rise in long-term interest rates. By and large, corporate credit—even junk bonds, as you see in another of Richter's charts at right—is presently of no worry. My suspicion is that the Fed is less worried about a *long-overdue* correction for stocks materializing provided that 1. Broad damage to corporate credit doesn't follow (*or precede*, for some reason) that and 2. A correction is not accompanied by any *systemic* or liquidity problems.


US CCC-Rated Junk Bond Yields Still Near Record Lows

ICE BofA US High Yield Index

Source: ICE BofA US High Yield Index, St. Louis Fed

Save for the tech-heavy NASDAQ, the broad stock market remains almost at its all-time high. **Though some of the recent selling has been messy and—in my opinion—a *little* indiscriminate, the broad story nevertheless still is one of more of a *rotation within* the stock market.** There is *no* sign whatsoever of investors fleeing this increased turbulence *to cash*; and most certainly, not to Treasuries or gold.

How all of this—and chiefly, the Fed's calculated risk to allow *some* steam to come out of things *within reason*—turns out, we can't yet know. I, for one, believe we are probably *closer to the end* than the beginning of this rebound in interest rates, however.

But *how* that comes about is up in the air. Will it be . . .

-- Within the next few months or so, when the current sugar high of a rebounding economy from a VERY low level plays out, and we are back to the "Zombie economy" that pretty much *can't* grow much no matter how much the Fed prints?

-- If/when increasing price pressures and a greater bond market rout cause a domino effect and (a la 1987) such an interest rate rise REALLY undermines risk assets more broadly? And, *especially* if such a course of events causes a frightened Fed to raise short-term rates before it wants to?

***Either* of these would lead to an end of the present *long-term* interest rate rises**. In the first scenario, *markets* would realize that the Fed's current propaganda is correct after all; and that there's little justification to push Treasury yields higher when "inflation" really isn't that big a threat AND when the economy still is underperforming. *The latter scenario is more worrisome and fraught with risk, though*; and among other things, might be what could prompt the long-discussed **yield curve control** on the Fed's part, whereby it "fixes" *long-term* interest rates.

-→ To me, the biggest takeaway in all this is that the Fed has *consciously* embarked on a course it hopes will lead to 1. Only modest further rises in long-term yields and 2. An orderly correction of *and within* the stock market. As I did for Members at week's end with some augmented recommendations, I'll continue to follow this development; and as others, look for ANY sign that the Fed is *next* of a mind to run up that white flag.

Don't forget that those of you so inclined can follow my thoughts, focus and all *daily* ! ! !

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