The Great Reflation Debate - Monthly Round Table Transcript

Margaret Kerins:

This is Macro Horizons, monthly episode 23, The Great Reflation Debate presented by BMO Capital Markets. I'm your host, Margaret Kerins, here with Ian Lyngen, Greg Anderson, Stephen Gallo, Dan Krieter, Ben Reitzes, Dan Belton and Ben Jeffery from our FICC macro strategy team to bring you our outlook for US rates, IG spreads and the US dollar on the back of the blue wave and its market implications. Each month, members from BMO's FICC macro strategy team join me for a round table focusing on relevant and timely topics that impact our markets. Please feel free to reach out on Bloomberg or email me at margaret.kerins@bmo.com with questions, comments, or topics you would like to hear more about on future episodes. We value your input and appreciate your ideas and suggestions. Thanks for joining us.

Speaker:

Margaret Kerins:

So quite a bit has happened since we recorded our last podcast in early December. We now have clarity on the Georgia elections that resulted in a blue wave. There is a new more contagious strain of the virus sweeping the globe, which is resulting in renewed shutdowns. All the while the vaccine rollout has been slower than expected. The market continues to look past this, to the eventual full reopening of the economy and ten-year yields have increased by 21 basis points since the end of the year on the reinflation narrative, which is sparked by the passing of the new round of fiscal stimulus, continued monetary policy accommodation, and expectations for a strong release of pent up demand in the second half of 2021. So let's start off with Ian Lyngen. Ian, what are your thoughts surrounding this latest market move and the reinflation narrative?

Ian Lyngen:

Well I was quite encouraged to see the backup in rates, because it was very consistent with this notion that we had been on about that there would be a push toward higher Treasury yields on the back of optimism that was brought into the beginning of the new year. I would actually characterize what we saw during the first week of 2021 as a bit of a bearish polar vortex, where we had all of the things that supported a higher rate narrative coming to fruition. We had the delayed blue sweep, we had, again, record high equity prices, we had people's expectations for inflation on the upside as forecasts were refined for 2021 and beyond. And then we had the Fed coming in and committing to continuing to buy bonds for the foreseeable future but beginning to lay the groundwork that at some point, they will need to taper back from that program.

Ian Lyngen:

And where did we get ten-year yields? Well, a solid shot at 125 still seems to be in the cards, but what I'm primarily looking for is to see at what level the current selling interest is met with demand. Now whether that comes in the form of solid overseas buying or domestic interest will be the primary question as we see where this sell off finally ends. In terms of the technical backdrop, all of the indicators that we're looking at are decidedly over bought, which suggests that the Treasury market should experience at least a period of consolidation, if nothing else, somewhere between that 115 and 120 level in ten-year rates. One of the bigger issues that I've been grappling with is just how far can this re-steepening of the curve play out. We're very much on board with the re-steepening trade and twos tens above a hundred basis points seems relatively straightforward to assume going forward. The underlying question is when does it all stop?

Ben Jeffery:

That really is the headliner question at the moment. And another noteworthy aspect of the moves we've seen in Treasuries to begin the year is that it hasn't really come at the expense of equity valuations. We've seen 2021 get underway with the S&P 500 setting record highs once again. And so in thinking about the next several weeks, several months, I think what's going to be really instrumental in assessing who ultimately will step up and buy Treasuries at these levels will be how well risk assets are going to be able to sustain these levels. Should we start to see any wobbles in equities or pickup in volatility I think domestic buyers and Treasuries will start to be interested and a foreign investor base that now has access to a pretty attractive yield will probably come in from the sidelines.

Greg Anderson:

That brings up an interesting point, particularly related to the behavior of Japanese investors. The steepening of the US Treasury curve creates yield enhancement opportunities for Japanese pension funds and insurers. With the 10-year Treasury yielding 115 to 125 basis points say, that's a big pickup over the roughly zero to 10 basis point yield on a ten-year JGB. But of course, switching from JGB's to Treasuries isn't that simple. It brings FX risk. Japanese investors tend to hedge that risk with three months forwards. In theory, a three month forward should cost somewhere in the 20 to 25 basis point range. That's assuming the Fed at 10 basis point base rate and the BOJ at minus 10. In practice with a bit of basis caused by excess demand for yen in the forward markets, the typical cost for the three month hedge is somewhere the 45 basis point range, that's where it was last summer.

Greg Anderson:

However, the hedge cost ballooned into the 60's in December due to year end pressures. But now in early January, it's back down to where it's 31 the basis points today. So all in with the hedge, a 10-year Treasury now has about a 65 basis point yield pickup over a 10-year JGB. Of course there are risks associated with this yield enhancement, like the basis risk on the rolling three month hedge, but I would still expect Japanese investors to do more of this trade over coming days and months, which will cause demand for long-dated US Treasuries to rise. Elsewhere in Asia, the biggest investors tend to be the central bank reserve desks.

Stephen Gallo:

On that point, Greg, I would say a couple of things. First, a number of Asian central banks, in particular, South Korea, Thailand, Indonesia, India, China, all seemed to have experienced foreign exchange accumulation in Q4. And so it certainly would be logical to assume that their reserve managers would be looking to buy duration on the way up in US yields. There's obviously a P&L angle there, but I also think the level of their foreign currency liabilities going into the pandemic is another reason why it's not in their interest for US dollar interest rates to move materially higher. And that brings me to the second point, which is risk management as it pertains to the balance of payments and foreign currency exposure in Asian economies. Certainly one of the biggest risks facing EM central banks is an abrupt reversal of capital inflows or a shortage of foreign currency liquidity.

Stephen Gallo:

And what we've also seen, particularly in the case of China, are efforts to slow the pace of appreciation in the domestic currencies in order to keep FX and balance of payments exposures in check. The question is does this have implications for the broad dollar? The answer I think is yes. And because China is such an important component of the dollar index, any efforts to mitigate capital inflows in Asian currency appreciation put the dollar on track for a pace of depreciation that is probably closer to 1% per quarter, as opposed to three or 4% per quarter. And that's roughly in line with our base case.

Margaret Kerins:

So those are some great points on the foreign demand and currency front. Let's take a step back and examine the risks in the market versus what is currently priced. The market is expecting strong GDP growth, increasing job gains, and eventual reinflation driven by an unleashing of pent up demand on the back of an extraordinarily high savings rate in the US and additional fiscal stimulus. So let's put this in a bit of context. This is all in the backdrop of a slim majority and swing votes in the Senate, which are likely to limit the ability of Congress to fully implement the Biden agenda and perhaps force the new administration to focus on a single initiative, such as an infrastructure program. This actually would be similar to the playbook followed by the Obama administration, which utilized the unified government in the first two years of his term to focus on and pass the Affordable Healthcare Act. So what is possible and what are the implications for growth and inflation if as our base case occurs or what happens if it doesn't given the slim majority in the Senate?

Ian Lyngen:

Yeah, if we do find ourselves in a situation where Congress is able to push through a single initiative, I think it would be fair to characterize that initiative as stimulus in one way, shape, or form, whether that is cutting $2,000 per household checks or an infrastructure deal, or frankly, a combination of the two, I think that the biggest takeaway from Washington over the course of the next two to three months, as a lot of this becomes more evident and consensus builds around the true expectations, will be that the results will become near-term stimulative. Now stimulative in two different aspects, of course.

Ian Lyngen:

On the one side, policymakers are attempting to provide a bridge for households and small businesses to make it into the post pandemic world. Now that might ultimately carry with it some inflationary implications, but at the end of the day, the bigger driver of inflation over the long term ultimately comes down to wage pressures. And given the significant dislocations that occurred during 2020, in terms of the frontline service sector workers who were effectively stopped out of the labor force and are now sidelined, not even showing up in the unemployment figures anymore, there's a lot of slack yet to be utilized. And that's been the message from the Fed. The Fed has been telling us that while we might get back on track by the end of the year, it will be a long time before monetary policy comes anywhere close to being normalized. And that has, from my perspective, two obvious outcomes.

Ian Lyngen:

One is an ongoing easing monetary policy bias, which drives inflation expectations, although not realized inflation. And the other is through the one type of inflation that the Fed has been able to create over the last decade is asset price inflation. So we see upward pressure on risk assets, equities, as well as domestic real estate. What I will be fascinated by will be what happens once we get through the March April base effects for the inflation complex. If we look at what has been driving prices during the pandemic, it was new and used auto prices, housing, things that you would think would perform well during a lockdown period for the real economy. Does the amount of fiscal stimulus in the system now ultimately translate through to demand side inflation for other things such as apparel prices, travel costs, shelter away from home? That's the biggest unknown and the market won't have true insight into that until well into the summer, frankly, once the May and June data becomes evident.

Dan Krieter:

Well Ian, you brought up two extremely important points I think. First you talked about the inflation component and how inflation is going to play out. Separating both realized inflation and inflation expectations. I think you made an extremely compelling case for how inflation expectations can remain elevated here for the next few months, even without realized inflation. But the other point that you made that I thought was very interesting was talking about the type of inflation that the Fed has been able to generate in the past decade and that's asset price inflation. And here I'm referring to what I saw as a shift in the Fed's messaging surrounding financial stability that started in the December FOMC meeting. At his Q&A in the past few months, Chairman Powell fielded a few questions on the topic of financial stability and he's always downplayed it. And then in the December meeting for the first time, he described the Fed's metrics that attempt to measure financial stability as a, "Mixed bag," and even went so far as to say that asset prices were, "A little high," in his opinion.

Dan Krieter:

So that was the first time at least I've ever heard the FOMC express any concern over financial stability. And I think when you look at the Fed policy through both the lens of financial stability and the inflation dynamics that Ian just laid out, the potential for inflation expectations to remain high alongside what's now expected to be a very, very large stimulus program, I think what that really boils down to is what we started the podcast by talking about, this return of the reflation trade, if you will. And at least in the spread market, after the blue wave came in January, we just set our spread targets higher in the wake of the Democrats seizing control of the legislative process, just because we came into the year expecting spreads to make new historical lows but now with this return of the reflation trade, as well as the potential for the Democrats to be able to push through taxation and regulation policies later in the year, even though our call for spreads to continue moving narrow in the near term remains unchanged, we don't think spreads may get as low as they otherwise would have.

Greg Anderson:

On the topic of inflation expectations, a big component of that, at least for those who drive, is the price they see at the pump. A year ago, so still pre pandemic, oil was in the high 50's. We're only in the low fifties now, but we've moved from about $40 a barrel in November to call it $53 a barrel today, more than a 20% rise in just over a month. That's a huge rally, especially when you consider that happened with renewed lockdowns in a lot of places around the world. Let's suppose oil sticks in the low 50's for the next three months, it would evolve from being a disinflationary component in January year over year CPI readings to neutral in February, and then a huge inflationary component in March because oil averaged only about $30 a barrel in March, 2020.

Greg Anderson:

This could cause a big spike in realized inflation numbers and inflation expectations in about three months time. And just to restate the obvious, that's not just a US inflation story, it's global. And it's a story that a lot of central banks will be grappling with at about the time they gather for the April G20 and IMF meetings.

Margaret Kerins:

So we've been talking about the reinflation trade and throughout the course of the pandemic, the Fed has basically been begging for a stronger fiscal response, and with the blue wave, they might actually get it. So while some of this is driving the reinflation narrative currently, a strong infrastructure plan that speeds up employment growth may have implications for monetary policy, meaning less might be needed. This begs the question of how markets that have seen great asset price inflation that Ian already mentioned would react if the Fed started to pull back earlier than expected. To be clear, that's not our base case, given 10 million jobs remain lost and the recovery and employment remains uneven in addition to the possibility that some behaviors and consumption may have permanently changed due to the pandemic, but it's certainly a risk.

Ian Lyngen:

Well I think that there's also the underlying argument that there is a true K shaped recovery underway. We have the defined winners and the defined losers from the pandemic. That is a relatively old story, but what we're now seeing is the ramifications from the winners effectively going out and using the spoils to bid up prices. When we see that occur, and we do have the upside on prices, whether that's in asset prices or eventually in consumer prices, that will further widen the gap from those who managed to remain in the labor force and those who were left behind. And that's the dynamic that the Fed is trying to address, trying to make sure we reach some version of maximum employment. Moreover, the Fed has a fair amount of credibility at risk. They went out with some very clear forward guidance and using what they said in 2020, it's very difficult for them to reverse course and all of a sudden in 2022, for example, put rate hikes back on the table.

Ian Lyngen:

So I would argue that the chances of getting off of the effective lower bound for policy rates are very low in the next two or three years, which is why the debate has centered around tapering or not tapering, whether that's at the end of this year or the beginning of the next, there does appear to be consensus building around the fact that the Fed has somewhere between 12 and 16 months left of bond buying before they need to change that program.

Margaret Kerins:

So Ian, in the backdrop of financial stability, the reinflation trade, that raises the question of can the Fed successfully walk the tight rope between financial stability and achieving their employment goals, which certainly are going to focus on the inequality and employment, which had not been necessarily a focus in the past? And we also have the combination of a Powell Fed coupled with a Yellen Treasury. So getting back to it, can they walk this tight rope successfully given the financial stability risks that may already be in the economy in terms of asset price inflation?

Ian Lyngen:

I think in that context, it's very important to consider what happens if they fall off that tight rope. What do they end up doing that hits equity markets, volatility spikes, financial conditions tighten, and they find themselves back buying bonds if they're unable to appropriately thread the needle. The risk to a sustainably higher spike in Treasury yields as a function of reflationary expectations really does come down to what can the equity market handle? What can emerging markets handle? What can credit handle? If the fact of the matter is the financial system can handle 10-year yields at 175 or higher, then the Fed would be content to see that unless there's some disruption to financial conditions. The underlying uncertainty or unknown at this stage is at what level do we start to see wobbles in equities? Do we start to see concerns and credit? Do we start to see the shift in a direction the dollar become more impactful for the economic outlook? These are all the primary uncertainties that keep me up late at night.

Margaret Kerins:

This is a good segue to the risks seen by the other members of the team and their different sectors. And what does keep you up at night, what are the risks that you see in the sectors that you focus on and cover?

Stephen Gallo:

In terms of my own personal views on risks, I would just point to the fact that many emerging markets were sitting on high levels of domestic and foreign currency debt going into the pandemic and those vulnerabilities are arguably worse now. Also EM central banks are not really in a position to tighten their own monetary policies aggressively in order to stem outflows because of those debt risks. And so I think there are lingering issues related to changes in western central bank policies if reflationary forces in the west end up being greater than in the past, and that could leave many emerging markets badly exposed.

Dan Belton:

With respect to the corporate credit market, the main risk that I see on the horizon is that inflation prevents the Fed from being able to remain as accommodative as it has been. An accommodative Fed has been the main reason that spreads are where they are right now, which is below pre pandemic levels. And if inflation starts to get away from the Fed and the Fed is unable to provide this amount of accommodation, we could see a rather disorderly move wider in spreads. Secondly, on the sectorial level, in the corporate credit market, there's a real risk that I think the market could be under pricing the amount of time with which it will take for certain sectors to return to normal. So for instance, after 9/11, it took about three years for air travel to return to pre 9/11 levels. And I think we could see a similarly slow recovery in certain service sectors and other sectors that were hit by the pandemic.

Margaret Kerins:

So that brings us back to the US rates outlook. And I'll pass it back to Ian, has your outlook changed at all on the back of the blue wave, following the Georgia election outcome?

Ian Lyngen:

Yeah, that's been an extremely topical question. And when I put together our rate outlook for 2021, I have assumed that the primary dynamic would be that of a range trade in which the upper and lower bound for yields were defined during different periods of the year. At the very beginning of the year is when we have historically seen that bulk of the optimism priced in which puts a short-term cap on how far rates can go up. And then as the realities of the data cycle play out, we tend to see downward pressure on rates emerge, and I can see the storyline playing out this year, we get past the reflationary impulse, we see the difficulty Congress might or might not have in getting new initiatives through, and then we settle back into the range that's been in place for quite some time. The question is how high are rates going to get during Q1?

Ian Lyngen:

I think it's reasonable to say that the blue sweep adds 10 to 15 basis points to both the upper and the lower bound of where we came in at the beginning of the year, but that hasn't led to a change in our year end forecast, which remains 125 for 10 year-yields, nor the chance that we'll see a dip lower in rates during the second and third quarter. Very consistent with the typical seasonal patterns and that implies that the dip by in interest we've been talking about does come to fruition. And those interested in adding duration exposure with 10-year yields closer to 125 ended up being the stronger hands for 2021.

Margaret Kerins:

Greg, on the FX side, how has this impacted your outlook for US dollar?

Greg Anderson:

The outlook for the door we'd give with a blue sweep versus not is about the same, about a minus 4% dollar index move for the year? The one thing that I would say is that the outlook for volatility or the probability you get a really big move is probably less. And for a couple of reasons, first off the blue sweep came with Janet Yellen, and I think she's a calming influence for foreign investors that caps dollar downside. And then the fact that other cabinet appointees will probably have an easy road to confirmation. It takes away a lot of the drama that you often see in the first couple of months of a new administration. And without that drama, there's less probability of dollar spikes. So same directional view, but less potential for volatility.

Margaret Kerins:

Ben Reitzes, how about Canada?

Ben Reitzes:

Our view in Canada is pretty similar to the US right now. There's a few quirks on the Canada side and that Bank Canada meeting coming up next week, there's the potential for a rate cut there. It's not our base case, but it's possible given what the Canadian dollar has done lately. And the new restrictions that have come in place through much of the country as the virus wave has taken a serious uptick here and that really looks like it's going to hit the economy hard in the first quarter. I think the biggest risk going forward is whether the vaccine rollout in this country is sufficiently fast to get to that second half point where we can really take off when the economy reopens and then whether that happens at all, even if we do get the vaccine fully rolled out. That remains, I think the key risks going forward. Near term, I think it's a question of how much the market's going to react to the softness that's coming in the economy versus that still cheery outlook that six months out or nine months out.

Margaret Kerins:

Thanks, Ben. So that's a wrap. Thank you to all of our BMO experts and thank you for listening. This concludes Macro Horizons, monthly episode 23, The Great Reflation Debate. Please reach out to us with feedback and any ideas on topics you'd like us to tackle.

Margaret Kerins:

Thanks for listening to Macro Horizons, please visit us bmocm.com/macrohorizons. We'd like to hear what you thought of today's episode. You can send us an email at Margaret.kerins@bmo.com. You can listen to the show and subscribe on Apple Podcasts or your favorite podcast provider. And we'd appreciate it if you could take a moment to leave us a rating and a review. This show and resources are supported by our team here at BMO, including the FICC macro strategy group and BMO's marketing team. The show is produced and edited by Puddle Creative.

Speaker:

This podcast has been prepared with the assistance of employees at bank of Montreal, BMO Nesbitt Burns Incorporated, and BMO Capital Markets Corporation. Together, BMO, who are involved in fixed income and foreign exchange sales and marketing efforts.

Speaker:

Accordingly, it should be considered to be a product of the fixed income and foreign exchange businesses generally, and not a research report that reflects the views of disinterested research analysts. Notwithstanding the foregoing, this podcast should not be construed as an offer or the solicitation of an offer to sell or to buy or subscribe for any particular product or services, including without limitation, any commodities, securities, or other financial instruments. We are not soliciting any specific action based on his podcast. It is for the general information of our clients. It does not constitute a recommendation or a suggestion that any investment or strategy reference here in maybe suitable for you. It does not take into account the particular investment objectives, financial conditions, or needs of individual clients. Nothing in this podcast constitutes investment, legal, accounting, or tax advice, or representation that any investment or strategy is suitable or appropriate to your unique circumstances, or otherwise constitutes an opinion or a recommendation to you.

Speaker:

BMO is not providing advice regarding the value or advisability of trading and commodity interests, including futures contracts and commodity options, or any other activity which would cause BMO or any of its affiliates to be considered a commodity trading advisor under the US Commodity Exchange Act. BMO is not undertaking to act as a swab advisor to you, or in your best interest in you. To the extent applicable, we'll rely solely on advice from your qualified independent representative making hedging or trading decisions. This podcast is not to be relied upon in substitution for the exercise of independent judgment. You should conduct your own independent analysis of the matters referred to herein together with your qualified independent representative if applicable. BMO assumes no responsibility for verification of the information in this podcast, no representation or warranty is made as to the accuracy or completeness of such information.

Speaker:

And BMO accepts no liability whatsoever for any loss arising from any use of or reliance on this podcast. BMO assumes no obligation to correct or update this podcast. This podcast does not contain all information that may be required to evaluate any transaction or matter, and information may be available to BMO and or its affiliates that is not reflected herein. BMO and its affiliates may have positions long or short and affect transactions or make markets insecurities mentioned herein, or provide advice or loans to or participate in the underwriting or restructuring of the obligations of issuers and companies mentioned herein. Moreover, BMO's trading desks may have acted on the basis of the information in this podcast. For further information, please go to bmocm.com/macrohorizons/legal.