Wake Me Up When September Comes - Monthly Roundtable Transcript

Margaret:

This is Macro Horizons, monthly episode 25, Wake me Up When September Comes, presented by BMO Capital Markets. I'm your host, Margaret Kerins here with Ian Lyngen, Greg Anderson, Stephen Gallo, Dan Krieter, Ben Reitzes, and Dan Belton from our FICC Macro Strategy team to bring you our debate on the base case for the US economic recovery and the implications for US and Canadian rates, high quality spreads and foreign exchange.

Margaret:

Each month, members from BMO's Thick 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@bimo.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 2:

Margaret:

So far this year, 10 year yields are about 50 basis points higher after reaching an intraday high of about 1.61% on February 25th, coinciding with the poor seven-year auction. The move was also on the back of Fed Chair, Powell's semi-annual report to Congress which reset the market's perception of the Fed's reaction function to higher rates. While Powell remained extremely dovish, he indicated that rising yields due to improving growth and inflation expectations is a statement of confidence by the market. Basically, it's okay if rates are higher for the right reasons. This leads us to another theme, the theme of global divergence. Recently, there has been a decoupling between the rest of the world and the US. So in the backdrop of the continued pandemic, vaccine rollout and another round of stimulus to provide a bridge to the consumer and incorporations through the latest leg in the pandemic, our round table discussion today begins with the disparity of the economic data on the ground today, characterized by high unemployment and a low participation rate versus expectations for an unleashing of pent up savings and what the new normal economy may look like later this year.

Margaret:

And let's just say, similar to the market, we're not all necessarily on the same page. So let's begin with Ian. This pivotal moment for the low rates thesis sparks the question, how high is too high in US rates, and will the market attempt to push rates to the point where the Fed is forced to act?

Ian:

Well, that is the underlying question in the market at the moment, how far can a 10 and 30 year yields back up before the Fed gets involved? Now, we came into this year assuming that there would be a period of bearishness where the upper bound of the range for rate trading would be redefined and established for the year ahead. I'm still assuming that that process is underway. And while we could see a challenge of that 160 level in 10 year yields, what I'm more concerned about is that the feedback from risk assets into tighter financial conditions will ultimately be what prompts the Fed into action.

Ian:

So as Powell pointed out, if rates are rising for good reasons, ie, an improving outlook, higher inflation expectations, market participants will be content with that until something breaks. And the question is, what will break and how quickly will the Fed need to craft a policy response to it?

Ben:

Ian, think you make a good point on the limits to how high rates can go. I think it's important to break down the way nominal rates come together between break evens and real rates. And the initial part of the backup, and rates kind of through the latter part of last year and early this year was primarily in breakevens and real rates were pretty steady. That's changed notably in the second half of February and the disorderly market that we've seen over the past couple of weeks. And then that's even more so in Canada than the US, has been driven by a back-up in real rates, as breakevens might have reached kind of a near-term peak here. I mean, breaks are already back to where they were or even above where they were pre pandemic. And, I mean, that begs the question of how much higher can they go. And if investors are depending on a backup in real yields to continue this steepening pressure on the curve, I mean, there's really big question marks on how long that can go on without asset prices really coming under a significant pressure.

Margaret:

Yeah, I think Ben and Ian, you raised some really interesting points. And getting back to the state of the recovery pre pandemic 10 year yields were probably around 187. And, we're still a ways from that. So, does it really become a question of what does the economy look like in six months? And the market is clearly pricing in some sort of a decent recovery. And so, if we get it, do we get back to the 1.82% type of levels.

Ian:

Well, I'd suggest that 1.82% in an environment where the Fed has the target Fed funds rate at zero is telling you something entirely different than the pre pandemic environment in which the economy was already facing some meaningful headwinds that ultimately resulted in the Fed needing to pause the process of normalization. So, a steep curve with a reasonably strong outlook at this point in the cycle, I think is actually reflected at, call it 161, 175 in 10 year rates, which then implies any challenge to that will trigger an in-range reversal. And it's that in-range reversal that I think is the biggest point of contention in the market, between the subset who believes that we're on a step function, higher and higher in rates and the camp that thinks that we're in the midst of setting the peaks for the year.

Dan:

Ian, I want to combine what you said with what Ben talked about with real rates being the real driving force behind the increase in rates last week, and just looking into the lens of potentially issue and starting to matter here. We've seen a lot more chatter in the last week about the potential expiration of Treasury's exemption at the GC of banks and for SLR calculations, and what that is an effective increase in Treasury supply. So, to me that says the market is at least on some level concerned about increasing Treasury supply going forward and a sort of consistent upward pressure on Treasury rates that will only be magnified if the FM recovery is as powerful as some expect, and that could have some serious consequences for US corporations that are heavily dependent on cheap debt. And we've seen a lot of refinancing over the past six, eight months because of low rates. If the rates are now going to be sustainably higher, I wonder if that's going to start impacting the profitability and ultimately viability of some US corporations.

Danny:

Yeah, Dan, we have talked about the potential for heavy Treasury issuance coming later this year to crowd out corporate funding. And once we saw Treasury rates find their footing towards the end of last week, and then yesterday, we saw a rush of investment grade corporates coming to market to issue debt, potentially because there's a fear that they won't be able to have rates and spreads at these levels for very long.

Margaret:

Dan and Danny, I think you raised an interesting point. But when I take a step back and look at where yields are outright, and also that spreads have retraced and are trading near post financial crisis tights, it's still a relatively attractive refinancing environment, even for debt that's been issued over the past, say decade. So it would take a substantial increase in yields, even from this point, for these corporations to be refinancing into a higher yield spread environment than persists currently.

Dan:

Yeah, that's a good point, Margaret. But also, I think it's worth highlighting, it's the beginning of January where we had a run-up in Treasury yields. I think they got to about 120 before they stalled out. And, we saw corporate supply take a break after that run-up. And I think corporations were maybe looking at a temporary increase in rates and wanting to wait until rates came back down to issue again. Now we see Treasury rates run up to 145, 150, and there's suddenly a crush of corporate supply, which tells me that corporations are not only worried about getting their funding off, but there's an appreciable chance that Treasury rates are going to be higher in the future, where maybe that belief wasn't so strong at the beginning of the year.

Dan:

So, Margaret, yeah, I agree. It's not like we're talking about bankruptcy here. Rates are still very attractive compared to historical's, but at the same time, corporations are also like to running much thinner margins as we deal with the economic repercussions of the pandemic. So, at the end of the day, it comes back to, how our robust is this economic recovery going to be, or are we going to see another round of bankruptcies? And I know that's not a concern just here in the United States, but around the world as well.

Stephen:

Thanks, Dan, you made some great points, but one thing that I definitely picked up on there is that right now you don't really see a case for widespread bankruptcies in the corporate sector, in the US. And I think that's an excellent way to juxtapose the situation in the US with what's going on in Europe. First of all, we have a more rapid vaccine rollout in the United States, and we're already seeing evidence of growth, momentum, and real stimulus coming into play. On the other hand, in continental Europe, you had a much slower vaccine rollout and you've got structural rigidity to begin with. You have less evolution in the labor market due to more furlough type support programs so that the labor market doesn't evolve. And I think that will ultimately translate into more distressed assets for banks and more hysteresis over the medium term, a very tough situation to deal with.

Stephen:

And to top it all off, the ECB is probably closer to implementing some form of yield curve control, which will prevent a steeper yield curve from helping domestic banks recover. And it looks to me, with the rhetoric we're hearing from ECB officials, that the March meeting next week is very much a live meeting in that regard. Bottom line is, I don't think you have a strong angle from a currency's perspective for the Euro here.

Dan:

Policy divergence is also notable in so far as we haven't seen thus far during the pandemic and such a different stance on the reaction of financial markets. So for the Fed simply to say, "Oh, we're okay and content to see rates back up," while the ECB seems to be saying the exact opposite, does suggest that global markets are entering a new phase,

Ben:

I think it just reflects the uncertainty that we're seeing with respect to the macro backdrop. While the US, again, as you mentioned the bankruptcies are not necessarily a huge issue yet and Europe is facing zombie corporations and maybe a weaker bank balance sheets, the situation in Canada is a little bit different, especially on the services side and the small business side, despite significant government support, a meaningful amount of closures, especially in the core urban areas that have been hit hardest. But that really hasn't stopped the economy from rebounding. We got fourth quarter GDP on Tuesday morning. It was much better than expected. And that's really been a theme. A consistent theme is growth. Kind of coming out of the initial plunging activity, has been better than expected in Canada and through much of the world as well. I guess the question is whether that continues and that will determine how comfortable policymakers are with the pace and the level to which rates end up rising.

Greg:

Thanks, Ben, for highlighting the relatively positive outlook for Canada, and thanks, Stephen, for underscoring the divergence between Europe and North America. The heterogeneity and disease fates as well as economic situations around the globe is remarkable. Some countries have fared much better than others, and I think that is only partially reflected in financial markets. For example, Australia has seen less than a thousand deaths from COVID-19, which would rank it as the fourth fewest in the US if it were a state. And the RBA estimates that Australia's output will be back to pre pandemic levels by the middle of this year, so no wonder in my mind that Australia is spike and 10 year yields has been much more exaggerated than the US is.

Greg:

Last week, the benchmark Aussie 10 year yield rose 50 basis points from 140 to 190. Then the RBA came in and intervened by buying three-year government bonds on Friday, and again, on Monday. The RBA has a 0.10% yield curve control cap on three-year bond yields that the RBA defended with three-year purchases, but it also bought further out the curve. In a policy statement released earlier today, the RBA said it might buy more to assist with the smooth functioning of the market. Might the Fed do the same? Also worth highlighting is the BOJ. It also has a yield curve control cap on 10 year yields that are set it at 0.00%. But last week, 10 year JGB yields got up to 18 basis points. The BOJ didn't intervene at that stage, but it has a policy meeting that's about 36 hours after the Fed's. I wouldn't be surprised to see some type of 10 year bond purchase by the BOJ and tinkering of its yield curve control parameters at that meeting.

Margaret:

So, in talking about the global divergence in Central Bank responses, it brings us back to the US economic recovery. And if the recovery is as strong as many are anticipating, US rates may continue to rise for the right reasons. But at some point, given this global backdrop of low rates and yield curve control, we should see demand for US Treasuries emerging due to the higher yields in the US. That brings me back to the corporate market and the possibility of bankruptcies on the back of higher yields.

Margaret:

And for me, it seems that, if we get a strong economic recovery and higher yields, that that type of environment should mean less bankruptcies. Now, obviously we've got more zombie corporations this time around, but it really all does depend on the pace of the recovery. Do we get the unleashing of the excess savings in the US? What does the reopening look like? Thinking about a full reopening on the back of the pandemic and thinking about urban centers, where there has been quite a bit of service sector damage, as Ben mentioned in Canada, but also here in the US, what does the reopening look like? What does this new normal look like if everybody's not back in the office full time, and it's work from home a few days a week? Will the unleashing of this savings rate be enough to offset some of these permanent changes in behavior?

Danny:

Yeah, Margaret, it's a great question. And I think with respect to the corporate market, specifically, like you said, it's going to really come back to the degree with which the economic recovery starts to progress in the next couple of quarters. And I think for corporates, like you said, there's never been more reliance on cheap debt than there is now for corporate balance sheets, and so the recovery from the corporate standpoint is going to take a lot of engineering and rethinking certain business models. Some sectors will not return to the way that they have, while other sectors I think there will be a good amount of pent up demand in the market, as long as there is a strong economic growth that starts to unfold in the next few quarters. But it's ultimately going to be a sector by sector thing, where there will be an increase in bankruptcies given this higher rate complex like you've discussed.

Ian:

You spent a lot of time talking about refinancing on the corporate sector and what that means for businesses, but one of the most direct ways in which the Fed can influence household balance sheet is through lower mortgage rates. And this backup in yields has been accompanied by a roughly 35 basis point increase in 30 year fixed rates. Now, by historic standards, mortgage rates are still very low. That said, the strength of the housing market has arguably been one of the surprise upsides for the pandemic and the Fed certainly doesn't want to see that trajectory change in any meaningful way. In fact, given the outright level of unemployment that's still evident in the US economy, especially when you factor in the depressed labor market participation rate, the type of upside that we are seeing in the housing market is a bit of a disconnect, and it's one that a reckoning might have more meaningful ramifications for the US economy than it would normally.

Ian:

So Margaret, earlier in the conversation, you made an interesting observation that a steady improvement in the real economy will lead to higher rates for the right reasons. I question just how much of that is actually priced in at the moment, especially with 10 year yields closer to 160 than 125. So in thinking about what is actually consensus at this point, what has surprised me is that most market participants that I speak with are using the projections of vaccine availability to assume vaccine uptake. So in the US most anticipate by September give or take people will have access to the vaccine. There seems to be conversations around but no solid expectations for just how much trouble the recovery scenario we'll get into if we don't have meaningful uptake of the vaccine.

Ian:

So one of my core concerns is, while reopening in September, October might be the consensus, when it comes to the second half of this year, we might be faced with a new set of realities in terms of people's willingness to get one of the vaccines and what that means for any of the restrictions, particularly in the travel industry, that one jumps out as an obvious risk.

Dan:

I agree with you, Ian, that international travel jumps out as an obvious risk. But I guess I take a bit more optimistic of a view here and I think domestic travel could actually increase a lot. I'm of the view that people are getting close to being done with quarantining, whether or not they get a vaccine, and when the summer weather gets here, that it's really going to be a very very strong economic environment. And that would have particular add on effects for the economy because we were observing the most damages into frontline service sectors, think of your bars, restaurants, hotels, that would benefit most directly from increased domestic tourism.

Dan:

I mean, if we all agree that international travel is going to be very hard to impossible for the next 12 months, maybe people are looking at taking that road trip, going to see cities in the US that they haven't seen. And I think that domestic travel potentially being much much larger than it's been pre pandemic, could be one particular driver of a strong economic recovery along the lines of what the market might be pricing to right now.

Margaret:

I guess the one question I would have on that front is, we still have restrictions in place with regard to visitation of some states, depending on where you live, which might hamper your ability to travel without quarantining upon your return for the 14 days. The other observation that I would have with regard to what Ian was talking about, on the vaccine uptake, we're a couple of months here in the US on the vaccine rollout, which of course was slow at the beginning and it's picking up speed quite rapidly. And the latest statistics that I've seen, state that about 41% of people aged 65 and older in the US have received at least one dose of the vaccine. And, the reason I bring that up is that's the most vulnerable group.

Ben:

Margaret, you mentioned the elderly being largely vaccinated and Ian, and you mentioned reluctance to get the vaccine. Two points there. One, the elderly really aren't the ones who drive the economy. They're not the ones who drive consumption. The working class folks, people with jobs, are the ones that tend to drive more of the consumption in the developed world. And folks that are unwilling to get the vaccine, I mean, I would guess their unwillingness is driven by a lack of fear more than anything else, of the virus itself. Because if you're scared enough, I mean, you're willing to get the vaccine. At least that's the anecdotal evidence that I hear around me.

Ben:

And so, if you have kind of the working class folks getting increasingly vaccinated as we worked through the course of 2021, there's a good case to be made for consumption to continually improve here. Income growth has come back nicely. And if you look at the latest month of income data, wages and salaries are actually above the previous peak. And so, that tells you that despite still a significant labor market scarring and still huge unemployment, the biggest driver for consumption which is income, has already fully recovered.

Dan:

And we haven't even talked yet about the high savings rate of the past couple of months. Obviously, that high savings rate was sort of mandated because people couldn't do anything with their money. But, how do you interpret that high savings rate? Do you look at it as people putting away money for what they expect to be rainy days in the future or do you look at it as money that hasn't been spent because there was really nowhere to spend it? And then once sort of the shackles come off and people are allowed to go back out again, is there just going to be a lot more money to spend? I tend to fall towards the latter half of that discussion that, particularly the young people that you talked about, Ben, that drive the economy, that they have more money now and are ready to spend it as soon as they can.

Ben:

That's the crux of the argument, Dan. And I think that's what separates the bulls and the bears, and that's why you're probably not going to get agreement until we see a resolution on that, what happens to all that pent up savings, if they keep it or if it gets unleashed and we see kind of the type of growth we haven't seen in some time.

Margaret:

I think in the same vein there, while that age group didn't drive consumption, they did drive the shutdown. Protecting the most vulnerable group and having the capacity in the hospitals to treat the people that were falling ill with this, drove the shutdown. And so, to the degree that that group is not protected, it may in fact allow a broader reopening as we get vaccinated, even if the uptake doesn't get to 80%. So kind of just arguing along the same lines as what we're talking about, but I do think there's also a flip argument.

Ian:

It also becomes a public policy question. What are the thresholds going to be to reopen? Now, we knew what they were at the beginning of the pandemic. We have a sense about the case counts. We have a sense about the trajectory of hospitalizations and what that means for in-person commerce but, when do we take our masks off? Does that require herd immunity? Does that require a percentage of the overall population receiving the vaccine or does it require a percentage of those considered to be the most vulnerable receiving the vaccine? And that's another key disagreement. Because if one is operating under the assumption that we need to have some true version of this theoretical concept of herd immunity in place before we can take our masks off, then that is going to be a much higher bar than simply protecting the most vulnerable. And I could envision a scenario where the public policy stance on this shifts to; as long as those with preexisting conditions are sufficiently protected, we can let the rest of the economy take the risks as they see fit.

Ian:

As it currently stands, however, that's not my impression of the direction that policymakers are taking.

Dan:

I think that what we'll end up seeing is policymakers in different states taking different approaches to that question. And certainly, red states, have been all through the pandemic pushing the envelope in terms of favoring economic activity over safety and I suspect that that would probably continue to be the case during the summer. So, you may well see some states masks off in June and others relatively shut down all the way into October, or longer

Margaret:

So this has been quite a dynamic discussion regarding the potential unleashing of the savings rate, perhaps as early as the summer, in addition to the timing of entering into the new normal phase, which may in fact be a little bit longer than the market's anticipating. So let's just do a quick bottom line from each team with regard to your expectations for where we'll be six months from now. We'll start with the US rates, Ian?

Ian:

So I think in six months from now, we will have come to the realization that the progress toward the new normal has not occurred as quickly as we are expecting it to at this point, but we will be a lot closer. And so, they'll still be a reasonable amount of optimism in the market. Rates will have found a new plateau. It will be with a one handle, not a two or three handle in the 10 years space, and we'll be looking forward to the tapering of QE as well as continuing to debate the first rate hike, which will transition us as a market to the belly of leading the moves in terms of bearish or bullish moments.

Margaret:

Let's move on to spreads.

Dan:

In spreads, I think that we're going to have a party in the summer and it's going to be a really strong economic environment. But six months from now, looking that far into the future, I think we could start to experience some hangovers from that party. I mean, ultimately there's going to be some business models that are no longer viable. There are going to be some companies that made it through the pandemic based off of stimulus, whether that's monetary or fiscal. And as economic growth is impressive during the summer months, I think the likelihood of more stimulus will start to drop and some of those businesses that have held on until now may realize that their customers aren't coming back.

Dan:

So, I think that will be a small subset, but it will be enough of a subset that spreads will start to move higher in the second half of the year based off of three things: first; higher Treasury rates at the plateaus Ian talked about, secondly; beginning to price and reduced fiscal and monetary support and potentially some higher taxation policies at the Biden administration will begin to focus on in 2022, and thirdly; that there are going to be some businesses that don't make it through the other end of this.

Stephen:

I would just end by giving an overview of the implications of the European recovery picture for the Euro. And quite simply, although I would expect there to be some improvement in the pace of vaccinations across the EU by the summer, the growth profile for now suggest that the Euro should continue to underperform in relative value terms, particularly against commodity exporting currencies in G10. It also looks increasingly like the Euro is poised to become a solid funding alternative to the dollar on a number of axes for the time being, and that includes parts of G10 and also parts of the EM space.

Stephen:

The only thing I would add for the EM space though, my final thought would be that, net foreign demand for their portfolio assets is likely to depend heavily on where US yields eventually settled down. US economic decoupling that drags dollar rates higher with it, depending of course on the extent of the divergence, is a key risk factor for non US issuers of dollar debt.

Greg:

Just to add onto what Stephen said, six months from now, I think we'll see sort of the darlings of this recovery higher. So, Australian dollar, New Zealand dollar, Canadian dollar, these are resource currencies that have benefited from the commodity price rally, which I would expect to extend and I would expect to see these currencies continue to outperform US dollar and, as Stephen mentioned, the Euro.

Margaret:

Ben Rietzes, you want to wrap us up with Canada?

Ben:

Sure thing. I'm still bullish on the macro backdrop for at least the next six months, and that's not going to change anytime soon, I don't think. There are just too many positives. And, if you look at global policymakers, Canadian policymakers, anybody, all Central Banks want to keep rates down here for as long as they can. Their challenge will be to keep the rest of the curve relatively well behaved to ensure yields don't rise too quickly. I think they're okay with them going up, but not too much. And so, I think that's probably the challenge. That'll be the story for the next six months or so, to kind of maintain that optimistic tone and ensure that markets don't get too disorderly.

Margaret:

Okay. And that's a wrap. Thank you to all of our BMO experts and thank you for listening. This concludes Macro Horizons, monthly episode 25, Wake Me Up When September Comes. Please reach out to us with feedback and any ideas on topics you'd like us to tackle. 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.

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