

Same As It Never Was - The Week Ahead Transcript

Ian Lyngen:

This is Macro Horizons episode 110, Same As It Never Was, presented by BMO Capital Markets. I'm your host, Ian Lyngen, here with Ben Jeffery to bring you our thoughts from the trading desk for the upcoming week of March 8th. And as market vol picks up and the pundits tout bears, bulls, hawks doves, and the occasional groundhog, The Orwellian parallels are hard to escape. Or was that Animal House?

Speaker 2:

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Ian Lyngen:

Each week we offer an updated view on the US rates market and a bad joke or two, but more importantly, this show is centered on responding directly to questions submitted by listeners and clients. We also end each show with our musings on the week ahead. Please feel free to reach out on Bloomberg or email me at ian.lyngen@bmo.com with questions for future episodes, we value your input and hope to keep the show as interactive as possible. So that being said, let's get started.

Ian Lyngen:

In the week just past, the Treasury market had two extremely meaningful inputs to help refine expectations going forward. The first came from Powell, the chair's reluctance to offer hints of the potential for an operation twist, or a shift in the weighted average maturity of the current bond buying program, was met with disappointment in some quarters. While an operation twist is surely at least on the minds of monetary policy makers, particularly given the chatter that we've heard from Europe, as well as other parts of the developed world, nonetheless, the lack of any outright commitment was certainly a key input as the market grapples to get a better understanding of the Fed's response function to higher rates. We've now seen 10 year yields back up once again, through that 160 level, we were eyeing 175 in the run-up to the ten-year auction. Given the performance of the recent seven-year auction, it will be difficult to assume that the market won't at least attempt to press the cheaper and steeper trade as the end of the first quarter comes into focus.

Ian Lyngen:

The other key input was in the form of the realized economic data. Specifically, we had a very strong nonfarm payroll print. The February growth in jobs is consistent with the reopening and the re-engagement on the service sector side as the economy slowly starts to emerge from the pandemic. This certainly has contributed to a more optimistic take on the pace of the recovery. This sentiment was also reinforced by Powell's comments. One of the other key takeaways from Powell's appearance is that the Fed remains in an extremely accommodative monetary policy stance at the moment. And we should expect that to continue going forward. The conversations regarding full and maximum employment suggests that the Fed won't be interested in lifting policy rates off of the effective lower bound for several years to come. Now the market, on the other hand, has attempted to pull forward the pricing in of the first rate hike into 2022.

Ian Lyngen:

Now, for that to come to fruition, we would need to see a lot of very positive things transpire, obviously the return of the service sector, the pulling in of the roughly 10 million sidelined workers that resulted from the pandemic as well as the increase in realized inflation that has been so elusive in the past for monetary policy makers. So in this context, the under-performance of the belly of the curve is really a Fed bet. So any flattening in the fives-thirties curve, for example, is predicated on the notion that the Fed will either choose to, or effectively be forced, to get involved via hiking rates long before they currently anticipate.

Ben Jeffery:

So, Ian, we got to our 150 target in tens, and now we're moving the goalpost up a little bit to 175. That's pretty bearish, are you feeling okay?

Ian Lyngen:

Oh, I am feeling a little bearish. Do I have to quarantine for that? In all seriousness, we did see a material shift in the market's perception of the Fed's response function to higher rates. A goal of 175 in tens, ahead of the auction, is very consistent with Powell's pushback against the market's assumption that the Fed was close to an operation twist, or somehow changing the composition of bond purchases, to focus more further out the curve. And as a result, it's difficult not to be bearish in the long end of the market at this moment. However, there is a very important caveat and this is what we will be watching over the course of the next several weeks. And that is, how our risk assets going to respond? We tend to focus a lot on the equity market, if for no other reason than it's one of the best real time gauges of investor sentiment. However, we'd be remiss not to at least acknowledge some of the risks for credit markets, as well as other sovereign debt.

Ben Jeffery:

And given what we heard from Powell, that's really going to be the operative unknown over the next four, eight weeks. I do think we've hit a fairly critical juncture in terms of, not necessarily just the sustainability of this higher rates plateau, of this higher yield environment and Treasuries, but related to financial markets, the corporate sector and households more broadly. Two prime examples of this are the ramp up in corporate issuance that we've seen, as corporates look to advantage of borrowing costs that are still low. I would argue that points to the expectation for even higher rates from that variety of buyer. And also the increase in mortgage rates that are now 30 basis points off the lows, which, while not as consequential as some of the supply side dynamics in the housing market, do introduce at least a little bit of a headwind to real estate compared to earlier this year and late in 2020.

Ian Lyngen:

And that's very consistent with what we saw during the last cycle where the Fed struggled to generate true demand side inflation early in the process, conceded that asset price inflation was the most likely outcome, at least initially, and then eventually we saw inflation pickup in the latter part of the cycle. The fact that we've seen asset valuations where they have been, stocks in particular, as well as housing, reflects in part the amount of fiscal and monetary policy stimulus that's been put into the system. As well as what I would characterize as a fair amount of optimism that the reopening is going to quickly lead to a recovery. And we'll be back to quote/unquote "normal" sooner rather than later.

Ian Lyngen:

The administration's announcements that vaccines will be effectively available to everyone who wants one by the end of May, which is two months earlier than prior projections, certainly has contributed to the reopening optimism. Although I'm still a little bit hesitant because I fear that the market is conflating

access to uptake. And what we might find is that, while doses are available, the moment where demand outpaces supply, which is where we are right now, we'll transition to the opposite and we'll get a better sense for the degree of reluctance on the part of certain segments of the population to embrace the vaccine. That's a big risk for the second half of 2021. Right now the market is still focused on the reflationary, reopening trade.

Ben Jeffery:

Ian, after Powell's speech, what do you make of the argument that, even though to some it was a bit of a disappointment, that the Fed is actually comfortable, or maybe even encouraging, a bit of a pullback in risk assets that run counter to some of these concerns about financial stability, asset bubbles, et cetera.

Ian Lyngen:

Yeah, I think that's a key component to the Fed's willingness to let rates drift higher, is they want to take some of the froth out of the market. But what happens when taking froth out of the market changes from a 5% correction in equities to a 25% correction inequities. That's the risk that the Fed is facing, and that's why I expect that the market will soon be more focused on the trajectory of financial conditions, than they will on the surprisingly strong nonfarm payroll report.

Ben Jeffery:

And on NFP, it was definitely a good read on jobs in February. We saw the private payrolls number at 465,000, which is the highest in over 30 years, excluding the large swings we saw during the pandemic. And within the details, we saw sectors like leisure and hospitality at 355,000 jobs, which is an encouraging sign given the damage that the pandemic wrought on those types of firms, specifically. As vaccinations continue and state and local governmental restrictions are rolled back, it follows that those types of firms most adversely affected are going to rebound more quickly. I also think it's worth circling back to an additional point on top of the one you made, Ian, surrounding the availability, and then ultimate willingness, of the populous to adopt the vaccine.

Ben Jeffery:

Throughout the entirety of the pandemic, there's been a very varied approach across the US in terms of lockdowns and restrictions on in-person commerce. We've already seen that theme continued as reopening has picked up, with several states lifting all restrictions, while others continue to have fairly substantial rules in place to continue limiting the spread of the virus. So in addition to the actual dose count itself, I think the calculus around the willingness of state and local governments to roll back some COVID measures is also a variable that cannot be ignored in evaluating the trajectory of the recovery.

Ian Lyngen:

When I saw that nonfarm payrolls print, one of the things that I couldn't help but think was, we're bringing forward some of the upside that the market was expecting later this year. So to your point, Ben, because it is a state and local government decision, in terms of reopening and lifting restrictions, we might be seeing the revival of the service sector earlier than the market was anticipating. But what that also brings forward is the risk that we plateau and we get a better look and understanding at what the new normal actually entails.

Ben Jeffery:

What the new normal entails sooner than we otherwise would have.

Ian Lyngen:

So then we're left to contemplate, what is the new plateau of the new normal? And I'll argue, frankly, that most people in the market have a sense of what to anticipate, but the details, for example, how much time will be spent in the office versus working remotely, how long it will be before business travel returns, how long it will be before in-person commerce and entertainment reach pre-pandemic levels. A lot of that is still uncertain. And the labor force mobility of the frontline service sector workers isn't such that we should expect that those job seekers will be willing to chase down a job out of town for relatively low wages. Especially in light of geographic ties.

Ben Jeffery:

And just to bring it back to the more near term, and what we expect during the trading week ahead, this bearishness that's playing out in Treasuries will benefit from the backing of March's reopening. Auctions of tens and thirties on Wednesday and Thursday. Now this week supply series is even more interesting than it otherwise would have been, given what we saw at February's seven year auction. Remember that was the worst seven's auction on record.

Ian Lyngen:

Oh, I remember.

Ben Jeffery:

So it will be telling to see if some bond vigilantes find vindication at tens and thirties, or if this latest backup in yields, coupled with the liquidity offered by the auctions, bring out some debt buying interest.

Ian Lyngen:

Another dynamic worth highlighting is from a flows perspective. March 31st represents the end of the Japanese fiscal year and historically that has been associated with repatriation of profits or the selling of Treasuries and position squaring into the new fiscal year. Now, this is very consistent with the seasonal patterns that also show upward pressure on rates in March. We've seen this evidence through the MoF data, that showed Japanese investors sold during a two week period, a total of \$34 billion in overseas notes and bonds. Now those numbers include other sovereign debt outside of Treasuries, but the vast majority have historically been Treasury transactions. So that's another factor that was surely at play during the seven-year auction. And one that, frankly, I will be concerned about as we face tens and thirties.

Ben Jeffery:

So that really does clear the way for the price action to run. And we've also reached the point, when we've heard from the Fed speakers that we're going to hear from, ahead of the March FOMC meeting. Powell was the capstone in this regard, and if we learned anything from that Q&A, is that the Fed is not going to step in to limit the rise in rates yet. If, in fact, there was a meaningful chance of an alteration to the bond buying program, the chair would have at least tried to lay the groundwork for that ahead of the March meeting in order to not catch investors by surprise. So really, this suggests a broadly unchanged policy statement at the March meeting. Even if we will get an updated summary of economic projections that will reveal the dovish convictions across the FOMC, not just for Powell.

Ian Lyngen:

Yeah, Ben, I think you're right. Radio silence is golden.

Ben Jeffery:

Uh-huh (affirmative).

Ian Lyngen:
Radio silence is golden.

Ben Jeffery:
Yeah, uh-huh (affirmative).

Ian Lyngen:
(Sighs)

Ian Lyngen:
In the week ahead, there will be three major events that we will be focused on. The first, on the data front, will be the core CPI print. This is February's data. Expectations are for a 2/10ths of a percent month over month increase. In Powell's recent comments, he stressed the difference between year over year base effects, which will be coming into play in the March, April and May data, and the three month annualized rate of growth for inflation. This will be key to keep in mind as we move into the second quarter, however, the February year over year data won't be as affected by this dynamic. The second event that we'll be watching is on the supply side, we have the reopening of the 10 year note, which is \$38 billion, and the reopening of the 30 year, which is \$24 billion. Given the reception to the seven year auction, as well as the fact that we're right up against the Japanese fiscal year end, it's difficult not to at least be somewhat cautious as we head into these auctions.

Ian Lyngen:
So this brings us to the third, and probably most compelling thing to watch in the week ahead, and that's the price action itself. 10 year Treasury yields up against 160 represents a material challenge to the lower for longer argument. And if we do see that break to 175, the behavior of risk assets in that context will be very important. If we see the retracement inequities translate through to a full correction, that'll have implications for financial conditions, which are currently at their tightest since November of 2020. And that has been a touchstone for monetary policy makers who have been reluctant to react to the recent back-up in rates. In addition, we're still grappling with whether or not the trajectory of the real economy can justify 10 year yields back in the range that they were between August, 2019, and December, 2019.

Ian Lyngen:
During that period, the unemployment rate reached 3.5% And Fed funds averaged 175 basis points higher than the current environment. For context, that range in 10 year yields comes in at 143 to 195. Now, admittedly, those are very wide parameters, however, we are at a very pivotal point in the recovery in terms of both velocity, as well as sentiment and market expectations. Powell put it very well when he said that the next two or three months are going to be very defining for the outlook for the balance of the year.

We've reached the point in this week's episode, where we'd like to offer our sincere thanks and condolences to anyone who has managed to make it this far. And as we contemplate the trajectory of 2021, we cannot help, but conclude if Ted Lasso can do it just about anything is possible.

Ian Lyngen:
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