A US Treasury Bear is Born

Bear markets typically begin cloaked in a spirit of denial. Confutation can be virtuous because decline owns up to problems and making a change to solve them is often too painful. It's human nature to seek pleasure to avoid pain. So, folks resist and hang on to their dogmas – unyielding beliefs like "*inflation hasn't happened and can't happen because demographics and technology won't allow it to happen – just look at Europe and Japan!*" Certainly, an entire generation has grown to acquaint a bond bear but for just a brief "hello" and a more celebrated long "good-bye". A wise market technician once told me back in the early 1980s that "*companies can keep on growing, but stocks can get overpriced"*. Well, strike the words "~~companies~~" and "~~stocks~~" from that incontrovertible wisdom and insert the words "*economies*" and "*currencies*". Now, if *economies can keep on growing, but currencies can get overpriced*, then what does that mean for the US dollar? Well, it too can get overpriced; it is overpriced; and ripe for higher (non-transitory) sustainable inflation.

US dollar strength is symptomatic of the Fed's <u>core</u> policy failure since the Great Financial Crisis – that is, inadequate sustained inflation! I know that dollar strength flagging failure is counterintuitive -- why would a central bank want its currency to be weak (it surely will never tell you that)? That's because it desperately wants inflation. It also wouldn't mind if inflation made refunding its country's sovereign debt a little easier. Afterall, a central bank's "boss" is the government which makes the rules. So, it's in a central bank's best interest (i.e., so it can stay "independent") to print enough currency to enable the government to print its debt; and often overprice its debt by using unlimited balance sheet power to help. Indeed, moderate constant inflation compels commerce because folks know that if they don't buy goods and services (i.e., "stuff") today, they will just cost more tomorrow – so, they buy stuff today and that activity impels immediate economic motion and growth. Deflation, on the other hand, is the friction that not only stops money from motion, but also stuff from being made. If folks know that stuff will cost less tomorrow, then they won't buy it today – unless the cost of doing nothing is too high. Negative interest rates can make the cost of doing nothing too high – so folks are impelled to spend or otherwise be taxed for trying to save. Negative interest rates are another symptom of failed central bank policy -- and excess influence with too much debt backed currency and not enough "free-form" currency. A free-form currency is fiat currency that is not backed by a financial asset (e.g., US Treasury-Bills that need constant refunding or repayment). Central banks need more of their fiat currencies circulating as "free-form" to grow and maintain targeted inflation. Technology advancements will soon enable central bank digital currency (i.e., "CBDC") to be free-form fiat currency – this paradigm shift will enable inflation.

I recall another wise market pundit once saying, "*there are only 3 things money can buy – a good, service or a financial asset.*" Well in fact, there is a 4^{th} thing money can buy – that's **influence**! Influence is the power to persuade and this power can be intoxicating – investors can become addicted to Fed influence to support markets and come to routinely expect more of it. Indeed, central banks are the world's greatest influencers. They can print the money to wield their influence which makes their power limitless, albeit, chronically inefficient. Central bankers print trillions worth of liabilities to buy trillions worth of financial assets. These assets are nothing more than other peoples' liabilities (e.g., US Government bonds and mortgage-backed securities) – and when rates go negative in the process of printing more money than there are available liabilities, bonds become truly worth more than money can buy (or return). This hapless process frustrates central bankers as policy fails to foster the inflation they need. The result is borrowers get paid to take lender's cash – an outcome of dysfunction based on an ineffectual policy of hope. That is, hope that as central banks inject more money into their financial system, consumers will rush to buy more of the stuff the central banks can't buy – that is, goods and services. Of course, hope is not a good investment policy especially when the money that's printed gets absorbed by equity valuations rather than by citizens who need it. In fact, frustration can morph to misery when too much of the stuff that does get bought is made (or outsourced) overseas. In America's case, the US dollars that get shipped overseas are then exchanged for US treasuries rather than for the home currency of the manufacturer that shipped the stuff here in the first place – this is what creates excess foreign currency reserves, which tend to prop up the value of the exported currency.

So again, the US dollar is overpriced -- inadequate desired inflation proves it. We expect central bank rules to soon change. In the United States, change will probably come under the social pressures of "equity". This should give the US Federal Reserve Bank's developing CBDC a political platform to launch its digital dollar. The implication would be for the Fed to become a direct depositor (mind you, I did not say "lender") through government directed policies. Currently, the laws provide that the federal government acts as the depositor (e.g., the COVID relief checks); and the Fed facilitates these deposits by creating the currency (to buy newly issued treasuries) so Treasury can clear their checks. Essentially, the Fed cannot direct lend, only banks can. But the federal government can tell banks what to do by telling the Fed what it will do – the Fed then testifies to Congress on its success (or failure). It is conceivable that congressional decrees may enable direct digital dollar deposits from the Fed directly into targeted checking accounts to promote racial equity and sustainable economic development among other things. Digital US dollars of the Fed could be *de facto* "contracts that invests in the people and promotes shared prosperity" – **and inflation** too (!) as CBDC will be magically block-chained and won't have to be paid back. CBDC's "claim" will be not only fiat, but also issued <u>against</u> a block-chained information asset rather than through the purchase of financial assets like treasuries. Recall that we often say that *central banks always get what central banks want*! That's because those that make the rules don't make the rules to harm them – they make the rules to serve them! It's just a matter time, trial & technology. So, "if at first you don't succeed, then try-try again…" That's exactly what the Fed has done and will keep on doing; and it (i.e., Congress) will change the rules (as needed) to get the desired public policy outcomes and intoxicating political power.

Last week, The Fed convincingly reiterated its policies will continue to be **outcome-based**. It explained 3 desired policy objectives: 1) improved labor markets to achieve maximum employment, 2) inflation above 2% <u>that is not transitory</u> and, 3) once it achieves better than 2% inflation, the Fed wants it to be on track to exceed 2%. Clearly, the Fed explained three objectives to highlight its determination to achieve two primary outcomes: 1) maximum employment and 2) sustained minimum 2% inflation. Chairman Powell probably focused on "transitory" to emphasize that immediate higher inflation expectations will not be viewed as sufficient to have met its 2% sustained inflation goal and that it will not be tapering its bond purchases any time soon. According to Chairman Powell, "*Substantial further progress toward its goals is needed*" and the Fed "*will signal well in advance that it believes its outcomes have been met*." He made certain to distinguish that the taper tantrum (2013) was triggered by a change in the Fed's outlook, but this time no signal will be given until its desired outcome has happened. In other words, the Fed will be very accommodative, and its guide will be a series of convincing data viewed through its rearview mirror. So, we expect that it will take a series of 2-2$^{1/2}$ % (or more) personal consumption expenditure reports for at least 4 straight quarters before the Fed signals it will slow its bond purchases.

But this doesn't mean that the yield curve has nowhere to shift but straight up like it has since January. The yield rise can take a pause and even reverse a bit before resuming. The Biden Administration's likely tax increase later this year will probably make the recovery grind a gear when shifting from recovery into expansion. This will make fiscal spending the primary growth fuel once the vaccine boosters are distributed. A tax increase would likely slow down the pace of rising long term interest rates (and pause the supercharged stock market) but not stop either from rising further because both monetary and fiscal policies (and changes) should work synergistically to aid an expansion. We expect some unique buying opportunities to prevail over the course of the year – especially in the $25par market if the long-term capital gains tax rate is increased. Hybrid financials should be among the recovery's top credit beneficiaries, and we expect hybrid spreads to tighten by as much as another 70bps along a path of rising 10yr TIPS rates to 0.50% or more. We believe the Fed will maintain its "zero bound" for the target funds rate at least until the real rate on the US Treasury 10yr note (i.e., the 10yr TIPS yield) spends a fair amount of time above zero as it trends to 0.50%. Indeed, we had warned that a Democrat controlled senate handing them full control of the federal government would likely accelerate the pace of rising longer-term interest rates this year -- our target of 1.75% for the US Treasury 10yr yield by yearend was met last week (though adjusted for inflation expectations, the real rate was still -0.60%). But as discussed, bear markets typically begin cloaked in a spirit of denial as some pundits believe negative longer-term nominal rates in the US are still inevitable – we think not, but time will tell. We believe that the Fed will achieve its goals and that a long-term trend reversal (now underway) points to rising US Treasury bond rates, a steeper yield curve and sustained desired inflation. If the shift to progressive policies in America gains momentum over the next three years, then sustained low rates and wide spreads should ultimately be replaced by sustained higher rates and low spreads as inflation flows through to higher equity prices and a cheaper US dollar. Importantly, the performance path to that end should bode relatively well for hybrids, which are enhanced yield (and lower duration) compared to investment grade corporate bonds; and enhanced credit (and lower default risk) compared to junk bonds.

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