Ostriching Central Banks - And What Investors Can Do To Get Ahead of the Stampede of the Big Birds

By Vineer Bhansali, Ph.D. | February 15, 2022

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With inflation globally running at almost 40-year highs, and the Fed having lost control of the narrative on inflation, one wonders what comes next, and what investors can do about it. Just to remind the readers who might have had their heads buried in sand for the last year and haven't visited a grocery store or filled their tank: inflation in the US, as measured by the CPI (consumer price index), came in at 7.5% and PPI (producer price index finished goods, non-seasonally adjusted) just came in at 12.2% (Source: BLS). It's the same story around the world. Inflation is raging, while the central banks are still buying bonds and pumping more money into the system. Nominal bond yields in the US are still under 3%, and real yields in intermediate maturities (as measured by TIPS) are negative. Yes, if we own these bonds we are paying 5% a year of purchasing power or so for the privilege. Time to take our heads out of the sand!

A good image to keep in mind while you read this is that of an ostrich. The ostrich has a small head on top of a very big body. Contrary to popular belief, it is not just a large, dumb chicken who buries its head in the sand to hide itself. Because it buries its eggs in the sand, its small head is hidden from view when it rearranges said eggs. Hence the myth of burying its head.

The Fed and the ECB have indeed laid some really large eggs when it comes to forecasting economic conditions, and are now trying to rearrange them. Actually, take that back – they continue to lay new eggs by continuing to buy bonds; i.e., putting billions of dollars of additional stimulus into the economy even as inflation fires rage, and sentiment of the common public falters with the rapid rise in prices. Not only does this ostrich continue to do more of what's not working, it tells everyone how and when it's going to do more of what is not working. Here is the New York Fed's purchase schedule just announced. Between 10:10 am and 10:30 am on designated dates, the Fed will come in and buy well-defined Treasury securities. Now why would they do that?

Let us go back to the three primary objectives of the Fed. They are, in a cyclical order: target unemployment, target inflation, and target financial instability. We now know that they have won the unemployment battle. We also know that they have lost the inflation battle, though one can always put lipstick on this bird and declare victory.

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So the ball moves naturally to the third objective: financial stability, which requires the banking sector as intermediary. A sudden stop to the Treasury purchases, in the face of accelerating inflation, will presumably create air pockets of illiquidity -- i.e., financial instability -- and upset the banks that own a lot of

these bonds that they were planning to sell to the Fed. That's not a good way to keep friends. The writing, however, is on the wall. If you own bonds as a non-bank, this is basically THE last call to sell it to the Fed. After that, you are mostly on your own.

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What comes next? Like a parent who has lost control of rowdy children, the next step will likely be an act of rash, credible irresponsibility – shock and awe, if you will, to show who's boss in this game of chicken. For the Fed, and perhaps for the ECB, this means an unexpected act that will put the market back in its place. And yes, there is precedent for that, though most people in the markets today may not have lived through it. Today, however, sticking it to the market for a short time might not be such a bad thing anyway, since the benefit is bringing back some fear of the Fed into the system.

There are three acts that would show the market today that the Fed means business. The first one is to simply renege on its promise to buy the bonds until March. Tough to do because the schedule is already published and the banks are likely already getting ready to sell the bonds back to the Fed; and yes, they will likely buy them back from the Fed later this year at a lower price when the Fed

starts the “runoff”. The second option is to beat the market’s expectations of a 50 basis point tightening in March and do 100 basis points instead. James Bullard of the St. Louis Fed has already floated that trial balloon (here), and the equity markets only complained a bit. The third option is to do an inter-meeting tightening. This was last done in 1994, and I well remember trying to catch that falling bond knife. Fortunately, my feathers were only barely plucked the last time the Fed fell way behind the curve.

So given that the Fed is likely to try to earn lost credibility by acting somewhat rashly, what should investors consider doing to avoid becoming poultry at Chick-fil-A? Obviously one cannot completely bail out of bonds, since even cash is effectively an overnight bond; the value of the cash depends on the issuer (the US Treasury) making whole on the obligation. Even a one dollar bill is backed by the full faith and credit of the US government. But what one can consider is reducing duration quickly.

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Duration reduction comes in many flavors. In the bond markets, it means exiting long duration bonds, both the nominal and the real kind, unless, of course, one needs to hold them for other, non-economic reasons or legal requirements. In equities, reducing duration means exiting growth stocks levered to low interest

rates and bond yields, and moving into assets that pay back dividends sooner rather than later. Credit assets, both investment grade and high yield, are long duration at current level of yields. In real asset sectors, reducing duration means exiting assets that compete with real bonds; e.g., gold and other precious metals. And yes, TIPS are going to get socked hard if you buy them at negative real yields. The effect of rising yields on bonds is very non-linear, since the discount factor is an exponential function of those yields. When yields go from negative to positive, the discount factor goes through a phase transition; i.e., think of heating water until it converts to steam. Lots of financial assets will indeed go up in smoke. Just observe what has happened to the universe of negatively yielding bonds globally in just a few months – they have dropped from almost twenty trillion to just a couple of trillion (Source: Bloomberg). And this despite the un-hinged buying of these bonds by the ECB and other central banks.

Back to ostriches. Did you know that not only are they the biggest birds on land, they are also the fastest birds on land? When central banks turn tail and run for the exits, investors will have absolutely no chance to get out of the stampeding bond markets in front of them. The best way to outrun the ostrich is to start running before it does.

Important Disclosures

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