The Fed is Ready to Break Things and Two Year Treasuries are the Place to be

By Vineer Bhansali, Ph.D. | March 25, 2022

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The message is clear to anyone filling their tank, or grocery shopping. Transitory is out, persistent inflation is in. The Fed is panicking, and investors who bet on the central bank propping up the bond market are trapped. The big elephant herd is running to get out of the keyhole. The year is already a debacle for the bond market. The stampede we called for has begun (here). The grand Modern Monetary Theory experiment is dead (for now), and inflation is here to put the gods of money printing back in their place (here). Central banks and commercial banks and funds who front run them gorged on these hot dogs (here) and now they are very very sick. The “misery index” is set to rise (the sum of inflation and unemployment) as we discussed (here). Having lived through 1994, when the non-maestro Alan Greenspan delivered an intermeeting tightening and shocked the bond market, we also discussed why that year is a good model for a panicked Fed. Recently a Fed governor used the same year as a model of what might be coming (here).

Ok, so this commentator has been writing about exactly this sequence for roughly three years now. But you surely do not want to hear “I told you so”. So we will now talk about what we can expect in the months to come and what we can do about it.

Quite simply, the Fed, already a “data-dependent” trader, will now act like a born -again tech entrepreneur. Which means it will act to move fast and break things that it erroneously created. The days of financial market support from the central bank are gone for now, it seems. Certainly FAIT(H) is gone (here). If anyone believed that the TIPS “breakeven” inflation rate (I.e. the difference between the nominal and the real yield curves of the same maturity) was an indicator of inflation expectations (it is not anymore because the Fed owns a whopping twenty percent or more of all TIPS and bought all of the issuance and more last year), even that indicator has gone way past the Fed’s target of 2% on average. Currently the two year breakeven is at almost 5%, and the five year forward five year breakeven is drifting higher. Inflation expectations are un-anchored. How many times have you recently heard…”I bought this or that for x dollars just a few months ago, and I thought I was overpaying, but now I can sell it for 20% more”? The Fed has become a victim of being dependent on the same data that it has distorted by continuing to buy assets in the face of inflation, and now the data is driving it, literally, to the edge of the precipice.

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As we have discussed before, the Fed has three objectives: unemployment, inflation and financial stability. Right now inflation is THE problem. And yes, the

Fed is a political creature, and has to show that it is following its “dual mandate”: price stability and maximum sustainable employment. And yes, breaking the economy and the markets is the only way to get inflation down. Like a deer caught in the headlights, Fed policymakers are looking at an angry Congress and an angrier mob ready to chase them out of their hallowed marble halls where they have gotten basically everything related to economic data 100% wrong. So this “numble” (nimble yet humble) Fed will talk about tightening 50 basis points each meeting until it catches up at least halfway to inflation. So short term rates of 3% to 4% by the end of the year? Possible. Inter-meeting tightening? Possible. And yes, they were stimulating by buying billions of bonds until last month. They still need to buy almost 100 billion each month just to keep the nine trillion balance sheet unchanged. So maybe stop recycling the maturity and coupons? Yes. How about selling the existing bond portfolio? Yes. Think about a crazy driver at the wheel of a semi driving at full speed with the handbrake on, and you get the picture of what is coming next…

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Somewhere between here and the time the vehicle stops, the economy will likely fall into a recession, stocks will crater, unemployment will begin to rise. In other words financial and economic instability will come back to be issue number 1.

Which means another round of stimulus, more bailouts, and perhaps outright purchases of the stock market by the government.

So what should investors do to get set up for this? My own view is that this is the time to be safe while earning some yield and rolling down the front end of the yield curve which will be the first one to pancake when something breaks. As the big elephant herd tears the door down trying to slip out of that keyhole, I will be hiding out in Treasury two year notes. Yes, I will still be losing real money to inflation for the next two years, but at least I know the principal will be returned, and it gives me lots of optionality in the interim. With a yield of 2.25% today (Source: Bloomberg) and a duration of 2 years I will make about 3% for a year with roll-down and carry. Not fantastic returns, but at least it's guaranteed to be positive if held to maturity. The least of all other evils while a confused Fed breaks stuff to show who's boss. And when stuff actually breaks, these 2s will be likely better than gold because they will probably be the most liquid asset to use to buy stuff from the debris. And yes, if the Fed pivots again, as I suspect they will have to, these 2s will possibly see some nice price appreciation too.

Important Disclosures

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