Moving The Goalposts: How The Fed Will Fix Distorted Perceptions it Created and What Investors Can do to Score

By Vineer Bhansali, Ph.D. | April 06, 2022

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By now it is common knowledge that the Fed (and the ECB) have not only missed on their recent economic forecasts, but also acted aggressively on these wrong forecasts that they now have to unwind. Amongst the many distortions that faulty policy has created there are three that have distorted the signaling mechanism of financial markets.

Market prices not only reflect demand and supply, but also signal what the market is thinking in aggregate about the future. Once the market "thermometer" is forced to stick to a preferred reading, it is impossible to tell whether it is freezing cold outside or sweltering hot. Right now, Central Banks are in a zone of maximum confusion created by their own actions, and the market is in the zone of maximum uncertainty, and the traditional indicators are not helping point to a clear outcome. The resolution of this confusion won't be pretty, but as always there are opportunities that are presented in times of uncertainty and elevated risks.

The first and most important signal that the Fed has distorted is the shape of the yield curve. Yield curve inversions, in particular, are well known by market participants to be a reasonably good predictor of recessions. Historically, that is. Right now, the Fed owns so many Treasuries that it has the power to make the yield curve shape whatever it wants it to be. So when Powell says that he does not think there will be a recession in the economy, we know that he is basically pontificating about his hopes ("hope is not a good policy strategy"), but he cannot really rely on the curve as a signaling mechanism, which the Fed basically owns via the trillions of Treasuries, to make that point. No wonder that, as the yield curve inverted sharply last week, the vice chair (Lael Brainard) came out and indicated that the Fed might start running off its $9 trillion balance sheet perhaps as soon as May (here), which was confirmed in the Fed minutes of the March 15-16 meeting! Now that's a pivot that will make the yield curve twist like crazy. Bottom line – the Fed can and will sell as many long-term bond holdings as it needs to so that the yield curve re-steepens. Indicator schmindicator. For all those folks wasting electricity searching "yield curve" on Google (see Google trend spike here), just forget about it. There, expectations fixed, recession fears solved.

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The second most important signal to pay attention to is the "breakeven rate" between nominal bonds and inflation protected bonds (TIPS). In a free bond market this difference would be a reflection of market expectations of future inflation. But as I have written for over three years now, the Fed has bought up a large fraction of the TIPS market, and because there are only so very few of them, the TIPS prices and yields are all goosed up. The admittedly wonkish five year forward five year breakeven is the implied inflation rate five years forward using the four legged combination of nominal and TIPS ten and five year bonds. This indicator, as of today is at 2.5%, which is about half a percent higher than the long-term inflation target, but just at the boundary of comfort for the Fed (Source: Bloomberg). To anchor inflation expectations, all the Fed has to do is to manage this forward breakeven rate down towards 2%. Then they can say – "look, the forward breakevens are coming down to our long-term target". Yes, in a world of expectations manipulation this can and will happen. And to achieve this objective, the Fed can sell a few extra longer term TIPS relative to shorter term TIPS. Given the size of their balance sheet this is not a tough thing to achieve.

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The third most important signal to watch is credit spreads. It should come as no surprise that credit spreads were compressed to an unprecedented level because the Fed and the ECB bought boatloads of corporate bonds. CFOs of the issuing corporations in turn used this free money transfer to buy back truckloads of their own stock. Tight corporate spreads mean (again through the wonkish "Merton model") high equity prices. High equity prices mean loose financial conditions. If the Fed wants to indicate that financial conditions are going to get tighter, a little nudge toward wider corporate spreads is all it will take. But not too much, because a stock market crash can easily occur, and that may throw cold water over everything.

To recap, here are the three indicators that have lost their time-honored signaling content: yield curve spreads, TIPS breakevens, and corporate bond spreads. But these three indicators of yesteryear are still potent tools for the Fed to paint its version of the future – the indicator is now a tool! And that is how they are likely to be used going forward – tools to move the goalposts.

What should investors do?

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First, to bet with the Fed's intent to steepen the curve, shorten portfolio durations. As I wrote in my previous post, I am hanging out in the short end of the yield curve; i.e, two-year notes in particular, while the Fed's newfound aggression breaks the bond market. In the meantime, I will settle for 3%-ish roll-down and carry per year, thank you very much.

Second, since we know the Fed can bring inflation expectations, as measured by the TIPS market, to whatever level it wants (it owns this "thermometer"), market participants might explore shorting longer term TIPS against nominals. Or, in wonkish terms, shorting longer term breakevens. My bet is that if the Fed really wants to put the inflation genie back in the bottle, it has to convince people that it has the resolve to do so, and so far the uber hawkish pivot of even the most dovish members shows that they have religion on this issue.

Finally, low quality credit exposure needs to be avoided and market participants might be best served by carrying a healthy skepticism of exposure to high flying equities.

To summarize: in order to declare victory and erase memories of inflation fiasco, the Fed is now on a mission to move the goalposts, even though this might mean roiling markets a bit. Investors who can anticipate this, can switch their aims too and score a few easy goals in the interim.

Important Disclosures

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