Inflation Fighting is Coming to an End, Financial Stability Concerns are Here - The Bank of England Pivoted and the Fed is Next

By Vineer Bhansali| September 28, 2022

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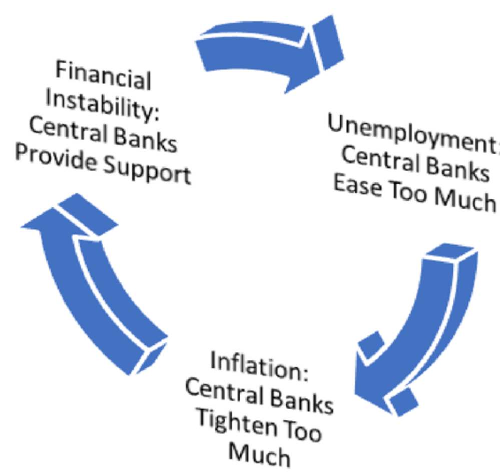
Today the Bank of England, just a few days before it was supposed to start running off the assets it had accumulated as part of the quantitative easing program, announced that it would buy unlimited amounts of UK sovereign bonds (gilts) to support market functioning. Here is the statement:

> *"In line with its financial stability objective, the Bank of England stands ready to restore market functioning and reduce any risks from contagion to credit conditions for UK households and businesses.*
>
> *To achieve this, the Bank will carry out temporary purchases of long-dated UK government bonds from 28 September. The purpose of these purchases will be to restore orderly market conditions. The purchases will be carried out on whatever scale is necessary to effect this outcome. The operation will be fully indemnified by HM Treasury."*



I have discussed this predictable central bank cycle in previous articles and which is summarized in the picture above.

"...the Fed will now have room to "pivot" to buying more assets in the name of "restoring financial market functioning."

Over the last few days, UK gilts and the British pound have seen a catastrophic loss of value. The catalytic event was a set of new measures announced by the new UK government that included massive unfunded tax cuts. The Bank of England says that this measure to restore market liquidity is "temporary". Sovereign bond liquidity is not only a mark of the credibility of a country and its central bank, it is also the high quality collateral by which financial leverage is facilitated, i.e. through "repos", "reverse repos", and other secured lending and borrowing.

First, the move is unlikely to be temporary because any attempt to remove the support of the gilt market will now result in a massive crash of UK government bonds and will likely take the Bank of England with it, which obviously cannot be allowed. Second, as I have written in this forum, with the massive pile of debt that the global central banks have accumulated, there is all the incentive to look for any excuse to not sell at a "loss" (of course the financial "loss" is technical since theoretically a sovereign can print unlimited amounts of currency to make up the loss. There is economic loss from misallocation of resources, which I will address in a different note). And thirdly, and most importantly, this is a precursor to the de facto central bank of the world, the Fed, to pivot. As mentioned in previous notes, the Fed will now have room to "pivot" to buying more assets in the name of "restoring financial market functioning". And who would argue with that? Given the choice between inflation of, say 4%-5%, or a total meltdown in the global bond and stock markets, most citizens will let the Fed have the wiggle room.

The Bank of England basically invented the concept of "debt monetization", to support historic English wars, and this is now a staple of central banking. Since its formation in the late 1600s, its main goal has been to be the banker for the government of England, supporting and financing its policies, good or bad. Today's action is another one in a string of decisions that shows that despite all the dog and pony shows of independence, the Bank of England is beholden to the government of today, and its policies.

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So what should investors do?

First, if the gilt market is the new "protected" asset class, then investors should not fight the Bank of England, and buy gilts along with them. Yields of 4% for a 10-year sovereign bond with an implicit put from the central bank seems juicy enough. Yes, you might not like it, but as investors it seems to be the path of least resistance.

Second, debt monetization is never free. This means that the stress has to come out somewhere. So unless the UK government suspends its fiscal plans, the pound sterling has to depreciate, because foreign lenders will require some compensation to lend to a government who cannot balance its budget.

Third, and most importantly, if the original central bank of the central banks can get away with throwing out its inflation fighting creds, then so can all the others. Remember, central bankers are a herd, and they go to the same holiday spots in the mountains, speak the same language, and report to the same political overlords. Which means that the Fed is next. And that means the US Treasury market, especially the short end of the yield curve, is a treat which would make my dogs drool. A two-year Treasury note at 4.25% with Fed protection!

As expected by this author and the market, now central banks have the perfect excuse to pivot. In a highly levered bond market, where sovereign bond prices are not only marks of credibility of the central banks, but also the lubrication for transactions and loans, this might be the pause in the great bond selloff of 2022. Inflation fighting is over. Financial stability is the next battle the Fed will fight. And that means a Powell pivot. Again.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, "LongTail Alpha"), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali's opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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