Trend Macro

Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

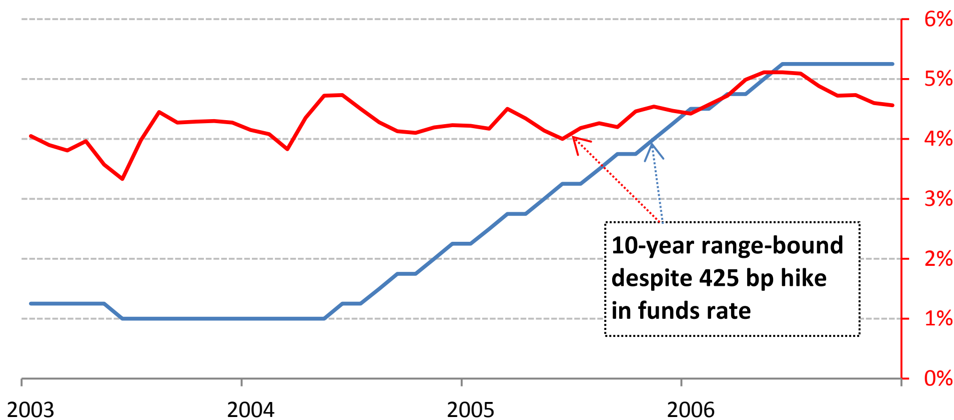
MARKET CALLS

US Fixed Income Strategy: The Fed Irrelevancy Hypothesis

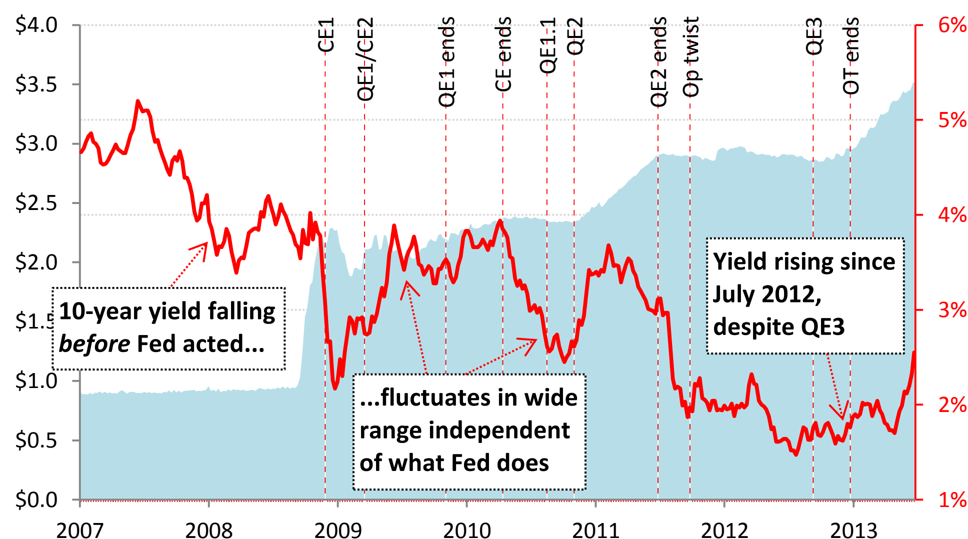
Tuesday, July 2, 2013
Donald Luskin

QE has no effect on yields. They've been rising for a year because systemic risk is lower.

Greenspan's conundrum: *funds rate* doesn't affect the 10-year yield
— 10-year Treasury yield — Fed funds target



Bernanke's conundrum: *balance sheet* doesn't affect the 10-year yield
— 10-year Treasury yield ■ Fed balance sheet assets USD trillions



Source: Federal Reserve, TrendMacro calculations

Update to strategic view

US BONDS, US FED: The panic over "tapering" is a red herring. The evidence shows that Fed policy has been irrelevant to long-term Treasury yields for a decade, ever since Greenspan's "conundrum." Yields are rising -- indeed, have been rising for almost a year -- because global systemic risk began to fall sharply after the ECB introduced Outright Monetary Transactions to rule out euro area sovereign default and currency break-up. Unless rising yields themselves trigger an increase in systemic risk, we expect them to keep rising -- the 10-year into the low 3's and the 30-year into the mid 4's by year-end.

[Strategy Dashboard home]

Copyright 2013 Trend Macrolytics LLC. All rights reserved. This document is not to be forwarded to individuals or organizations not authorized by Trend Macrolytics LLC to receive it. For information purposes only; not to be deemed to be recommendations for buying or selling specific securities or to constitute personalized investment advice. Derived from sources deemed to be reliable, but no warranty is made as to accuracy.

As we think strategically about the future of long-term yields, our research leads us to the hypothesis that *the Fed is irrelevant*.

- This seems an absurd thing to say in light of the panic the last two weeks over the prospect of the Fed "tapering" and then ending its Large-Scale Asset Purchases (see "On the June FOMC" June 19, 2013).
- It flies in the face of years of claims by central banks around the world that their rate-targeting, forward-guidance and Large-Scale Asset Purchases (LSAPs) work, in part, by manipulating long-term yields.
- *But the evidence over the last decade strongly supports the conclusion that whatever else central banks may be doing, they are not directly moving long-term yields.*
- In 2005 former Fed Chair Alan Greenspan spoke of a "conundrum" -- that large hikes in the fed funds rate were apparently having no effect on long-term yields (please see the top chart on the previous page). Indeed, by mid-2006 the funds rate had been hiked by 425 bp, and the 10-year Treasury yield had barely budged.
- Fed Chair Ben Bernanke doesn't acknowledge that today's Fed faces the same condundrum. He claimed as recently as the last FOMC news conference that LSAPs lower long-term bond yields. Yet just by looking at the evidence of the data we can see this isn't true (please see the bottom chart on the previous page).
- *The plain reality is that long-term Treasury yields have been falling, broadly, since mid-2006, before the global credit crisis struck and before the Fed lowered the funds rate or grew its balance sheet.*
- During and after the crisis, yields fluctuated within the context of overall decline -- usually *rising* when the Fed *bought* long-term Treasuries, and *falling* when the Fed *paused* its buying (please see the chart below). *For the most recent policy episode, the 10-year yield is higher now than when QE3 began.*

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

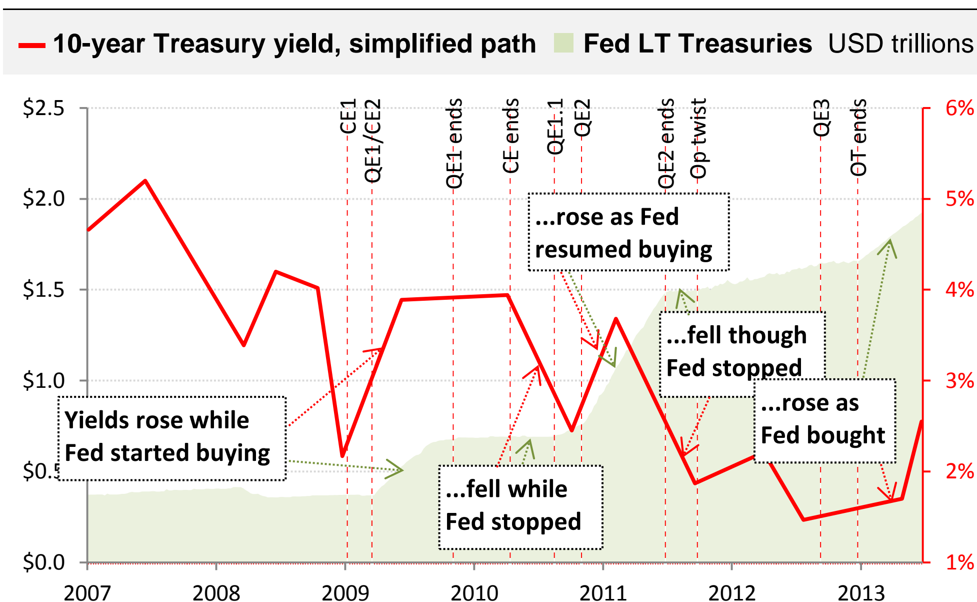
Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

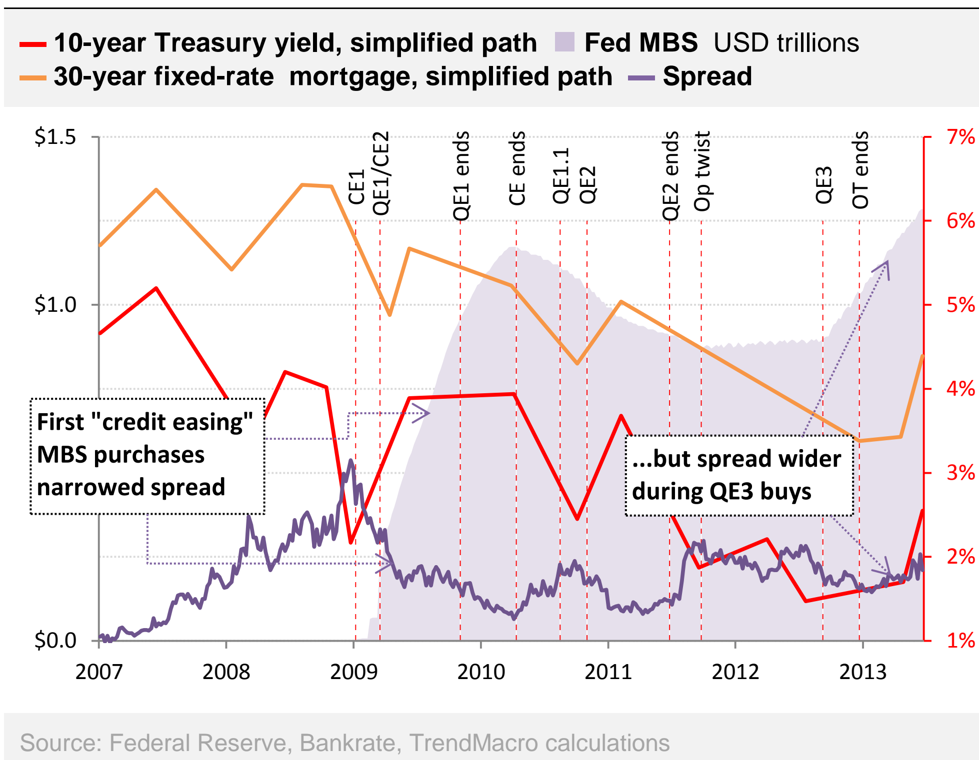
[About us]

10-year Treasury yield, simplified path **Fed LT Treasuries** USD trillions



Source: Federal Reserve, TrendMacro calculations

- There is an evidence-based case to be made that the Fed's very first LSAP -- the agency MBS buy program [announced] on November 25, 2008, begun in January 2009 and enlarged in March 2009 -- succeeded in narrowing the spread between 30-year fixed-rate mortgage rates and the 10-year Treasury (please see the chart below).

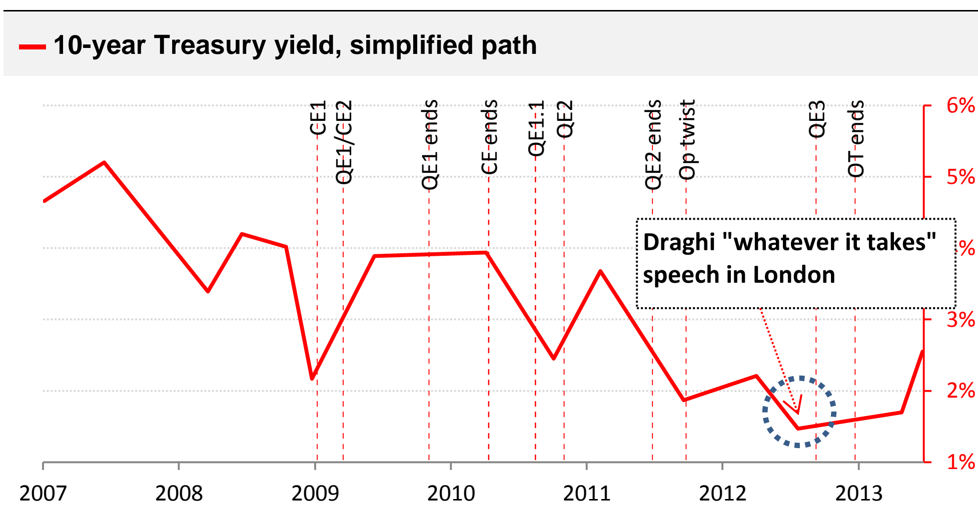


Source: Federal Reserve, Bankrate, TrendMacro calculations

- This program was a classic 19th century [Lombard Street] central bank intervention *for the sake of market stability, not monetary policy as such*. The idea was not to manipulate interest rates or bank reserves, but to extract pariah assets from the marketplace to avoid a vicious cycle of panicked fire-sale dumping. This is why [Bernanke at the time] was careful to call it "credit easing" (CE on our charts), as distinct from "quantitative easing" (QE on our charts).
- But the latest round of MBS purchases under QE3 have had no such distinction, and they have failed. *Mortgage rates -- and the spread to the 10-year -- are higher today than when QE3 began* (again, please see the chart above).
- Perhaps the success of the first credit easing was because it was the *first* LSAP, and because it came at a time of particularly acute need -- it was low-hanging fruit. Such may be the case today for the Bank of Japan's LSAPs (see ["On the April BOJ Policy Meeting"] April 4, 2013). But in Japan, too, the effect on long-term sovereign yields has been the opposite of stated intention -- they have risen, not fallen, because the BOJ has increased inflation and growth expectations (see ["On the June BOJ Policy Meeting"] June 11, 2013). Today, for the Fed, with no crisis upon us, fourth-generation LSAPs are operating far down the diminishing returns curve. Why should we expect any particular effect on long-term US yields?

Despite the clear implications of a decade of evidence, we bear a burden of proof to explain the sharp back-up in yields since the market began to focus on the possibility of the Fed tapering LSAPs.

- We're disposed to see this as primarily a coincidence -- a speculative effect, a thought contagion.
- The fact is that yields did not begin their recent sharp back-up when Bernanke dropped his unmistakable hint about tapering in congressional Q-and-A in late May (see "QE Steps Down Before Bernanke Does?" May 23, 2013).
- The recent sharp back-up began on May 3, after the April Employment Situation report strongly beat expectations and revised away two months of disappointing payroll growth (see "On the April Jobs Report" May 1, 2013).
- To be sure, it could be argued that this better-than-expected jobs report triggered a back-up in yields *because* it would lead straightforwardly to the Fed beginning to taper LSAPs. But we aren't inclined to accept that explanation. It is just as likely that the report led only to expectations for faster growth, which is completely consistent with higher yield, Fed or no Fed.
- But that leaves the fact that yields had already been rising for more than eight months *before that jobs report was even released*.
- The 10-year yield bottomed at 1.38% -- *the lowest yield in history* -- on July 25, 2012, almost a year ago. *Since then yields have been rising through good jobs reports and bad -- and before QE3, during QE3, and now with the possible end of QE3 in sight.*
- And it's not rising inflation expectations, thankfully. TIPS spreads are lower today than at last year's bottom for the 10-year yield, and the inflation-sensitive gold price is far lower.
- So we must search for a key event to explain the back-up of yields from the all-time low about one year ago.
- The back-up began the very next day, July 26, 2012 -- the day that ECB President Mario Draghi gave his "whatever it takes" speech in London (please see the chart below) -- while Spanish sovereign



Source: Federal Reserve, TrendMacro calculations

yields were spinning out of control and threatening a third year in a row of euro area existential crises of debt default, bank insolvency and currency break-up (see "On Draghi in London" July 26, 2012).

- A week later, at the ECB's next policy meeting, Draghi began to turn his abstract pledge into the Outright Monetary Transactions program -- a standby "credit easing" commitment to buy distressed sovereign debt (see "Draghi: Off the Reservation" August 3, 2012).
- *This is key, because OMT put an effective safety net under a systemic risk factor that threatened a Lehman-like global banking collapse in 2010, 2011 and again in 2012.*
- That risk flared up in each of those years, approximately at the same time as bottoms for the US 10-year yield. *While the systemic threat from Europe loomed over the global economy, it was sensible to build a premium into the highest quality sovereign debt, such as that of the US. With that threat removed, yields can rise because safe-haven assets are no longer so highly valued*.
- A similar explanation based on reduction in systematic risk has been offered in academic research into Greenspan's "conundrum" of the mid-2000s (see, for example, "Cracking the Conundrum" by Backus and Wright, 2007).
- As we have already noted a number of times recently (see, for example, "To Taper or Not to Taper?" June 7, 2013), the FOMC had systemic risk very much on its mind when it met in September 2012 and initiated QE3 (see "Rethinking QE3" September 18, 2012). It was worried not only about risk from Europe (it wasn't as evident then as it is now that OMT would succeed in ruling out a sovereign debt crisis) -- but also about the coming year-end fiscal cliff, a US debt crisis as the statutory borrowing ceiling was hit, and a potential hard-landing in China.
- *While the Fed failed to lower long-term yields with QE3, that was never the intention. The intention was to hedge against systemic risks.*
- As it turned out, none of these risks materialized. This has been the key not only to rising yields, but also to strong equity performance since mid-2012 and into 2013 (see "Oh What a Relief It Is" January 23, 2013). Starting a year ago, the world has become a less and less risky place.
- The Fed sees it the same way. The FOMC said in its statement two weeks ago that it sees "downside risks…having diminished since the fall."
- So while we have grave doubts that the Fed will in fact taper LSAPs as soon as the market now expects (see "Taper Your Tapering Expectations" June 27, 2013), from the standpoint of long-term yields, it's not clear to us that the Fed matters at all.
- *If the amount of systemic risk is the key to long-term yields, then what matters from here is the amount of systemic risk.*
- As we noted three weeks ago, using world equity volatility as a proxy for systemic risk, by our dead reckoning the US 10-year yield ought to be in the low 3's and the 30-year ought to be in the mid 4's (again, see "To Taper or Not to Taper?"). Other proxies, such as forward multiples, tell a similar story.

Recommended Reading

Cracking the Conundrum
David Backus and Jonathan H. Wright
Finance and Economics Discussion Series 2007-46
Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board

[Reading home]

- Over the last two weeks, the panic over the possibility of the Fed tapering and ending LSAPs seems to have led to a temporary flare-up of systemic risk -- in China's interbank market and in Europe's sovereign debt spreads (again, see "Taper Your Tapering Expectations"). For a few days our paradigm was violated and the polarity of cause and effect was reversed -- yields rose while systemic risk increased, as it seemed that rising yields were *causing* the systemic risk.
- Those risks have died down considerably over the last several days, so perhaps we can write them off as nothing more than a meaningless speculative reaction.
- But let's assume that there really is some causal connection here -- that higher yields are creating those risks. *If that is so, then under our theory that the Fed is irrelevant, it would make no difference whether or not the Fed dialed back tapering expectations in response, because the Fed can't control long-term yields in the first place.*
- So if these risks are in fact aggravated by higher yields, then we have to accept the reality that an equilibrium will impose itself no matter what the Fed does -- *the rise in yields will be capped by any consequent rise in systemic risk, because that risk (not any Fed action) will lower yields as investors value safe-haven assets more highly.*
- So the judgment call about long-term yields hangs on an appraisal of potential systemic risks -- and the ability of local central banks to act appropriately as lenders of last resort to curb those risks.
- Our default position is that the People's Bank of China and the ECB will keep the lid on the risks faced in their respective markets, at least for this year.
- So while we don't expect a continuation of the headlong panic in US yields we've seen over the last weeks, we expect yields will work higher over the remainder of the year. We expect to see the 10-year in the low 3's and the 30-year into the mid 4's by year-end.

Bottom line

The panic over "tapering" is a red herring. The evidence shows that Fed policy has been irrelevant to long-term Treasury yields for a decade, ever since Greenspan's "conundrum." Yields are rising -- indeed, have been rising for almost a year -- because global systemic risk began to fall sharply after the ECB introduced Outright Monetary Transactions to rule out euro area sovereign default and currency break-up. Unless rising yields themselves trigger an increase in systemic risk, we expect them to keep rising -- the 10-year into the low 3's and the 30-year into the mid 4's by year-end.