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MACROCOSM

Thank God for Yellen's Conundrum

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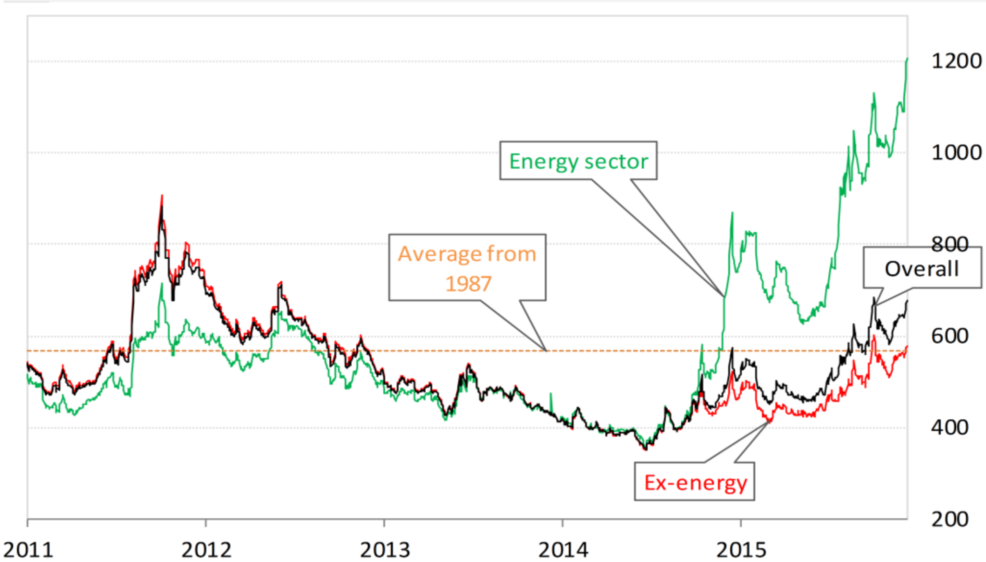
Long Treasuries aren't budging as "liftoff" nears: it's going to be "one-or-two and reversed."

Brent crude traded below $40 for the first time in six years after OPEC's closely watched meeting. There was absolutely no surprises in the cartel's decision to keep pumping. And yesterday's Department of Energy Short Term Energy Outlook report revealed a massive upward revision in September production -- almost all from offshore -- which explains the quarter's otherwise inexplicable rise in crude inventories even as shale production has strongly rolled over (see "Data Insights: Oil" December 8, 2015). That's a useful explanation, but it's not news.

- So it strikes us that all the news is out for oil. So we can probably think of the new lows, generally, as forming of a sloppy double-bottom with the August trough. The risk for oil is that it gets caught up in deflationary dynamics from outside its own physical markets.
- *But even if this is a bottoming process for oil, it does real damage. Non-investment grade credit spreads in the energy sector have blown out to new highs (please see the chart below), contagiously creating a severe tightening in credit conditions just as the Fed is about to hike rates.*

US non-investment grade bonds, spread to Treasuries



Source: BAML, TrendMacro calculations

Update to strategic view

OIL, US STOCKS, US FED, US MACRO, FX, ASIA MACRO, US BONDS: New lows for oil on no news for all -- it probably means all the negatives are out, making what amounts to a double-bottom, and leaving only surprises on the upside. Yet there's a deflationary smell in the air, as "liftoff" approaches next week -- a mistake based on a misbegotten belief in the Phillips Curve. The Fed is ignoring that the back-up in credit spreads, accelerated by new agonies in the junk energy sector, is already the equivalent of thirteen rate hikes. Good news: long-term Treasury yields haven't budged, signaling that markets see the deflationary implications of a "liftoff" error. This supports equity valuations through equity risk premia. It is also good that the RMB continues to weaken, as we expected. These factors limit the depth of the tantrum that will make this rate hike "one-or-two and reversed."

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- *From the narrowest point in the credit cycle since the end of the Great Recession, on June 23, 2014, the overall non-investment grade spread has almost doubled, widening by 323 bp -- which we could think of as the equivalent of thirteen Fed rate hikes. Investment grade spreads, over the same period, have widened by about 100 bp, or four Fed rate hikes.*
- This widening has occurred, precisely, since the time we called the top in global oil prices, and correctly anticipated they would crash (see "The Stench of CrISIS" June 25, 2014). The lower oil has fallen, the more spreads have widened.
- This is a substantial tightening of financial conditions, and it is the main driver of our call for the first-ever recession caused by too-low oil prices (see, among many, "Another 'Reverse Oil Shock'?" Tuesday, July 28, 2015), and it will only exacerbated by the coming Fed "liftoff."

That "liftoff" is a mistake can be seen most clearly in the long Treasuries market. With "liftoff" now all but a reality only one week away, 10-year and 30-year yields are right where they were a year ago and lower than they were six months ago. This is Fed Chair Janet Yellen's own personal "conundrum."

- But is it so much of a mystery?
- It means that "liftoff" is a deflationary event…
- …which means that the October FOMC's conviction that, through the operation of the Phillips Curve, inflation will "rise gradually toward 2 percent over the medium term as the labor market improves" is wrong (see "On the October FOMC" October 28, 2015).
- It means that the market believes what we have come to call "The Yellen Rule" -- that even in an extended hiking cycle, the terminal funds rate will be quite low by historical standards (see, among many, "The Yellen Rule is Taylor Minus Two" May 19, 2014).
- Or, more extreme, and we think more likely, the market believes that "liftoff" will be not just "one and done," but "one-or-two and reversed," as proved to be an urgent necessity when the ECB under Jean-Claude Trichet executed a similarly mis-timed "liftoff" in 2011 (see "EUicide" April 7, 2011). We can't think of an example of a central bank rate hike since the end of the Great Recession that *didn't* have to be reversed.
- How much the worse it would be if markets actually took Yellen seriously. A back-up in long-term Treasuries would narrow the equity risk premium, creating a dangerous shift in relative valuations. As a six-and-a-half year bull market in stocks has matured, it is only extremely low Treasury yields that have kept stocks relatively attractive. Losing that advantage could suddenly undo the wealth effects which were probably the only measurable good achieved by the Fed's quantitative easing (see "Is the Fed Moving the Stock Market?" March 11, 2013).
- As an arithmetic matter of sensitivity via the equity risk premium, a 100 bp back-up in the 30-year yield would cost the S&P 500 about

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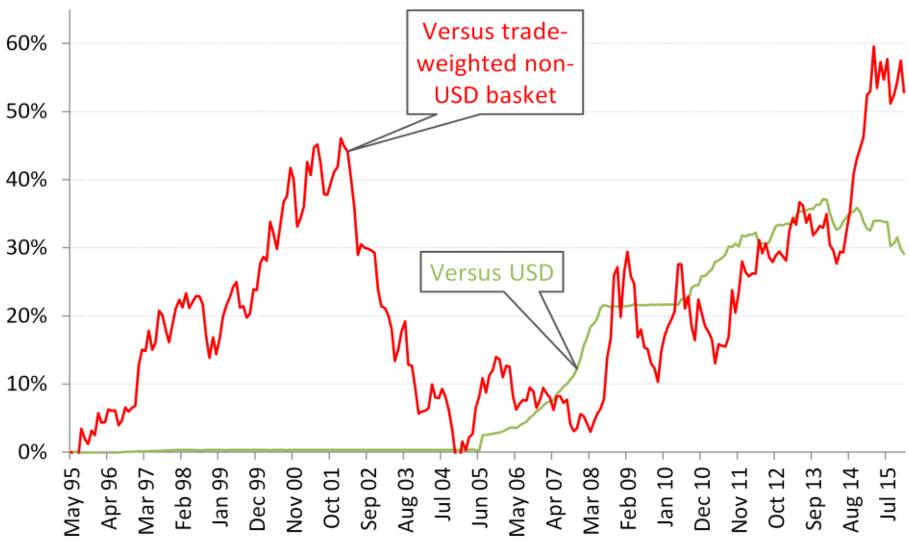
25% of market capitalization.

- Indeed, the long correction in stocks began from the May all-time highs when non-investment grade spreads first began to blow out. Stocks haven't had to endure a competitive onslaught from the massive long-term Treasury market, but higher junk yields seem to have already taken a toll.
- There's something of an automatic stabilizer at work here, though. To the extent that the upcoming Fed tightening error is deflationary, that will be bad for credit and bad for growth and bad for earnings -- and bad for stocks. But it will be good for bonds -- that is, it will keep Treasury yields low (and drive them lower) -- and that is an offsetting good for stocks, at least in terms of relative valuation.
- We're assuming here, as a base case, that "liftoff" won't ignite some non-linearity in USD strength that would quickly transmit into a tipping-point for China, which is struggling with a massive appreciation of its currency thanks to the USD-peg (please see the chart below).

Strengthening of the RMB from May 1995



Source: Bloomberg, TrendMacro calculations

- With this particular risk in mind, we see it as a positive that, as expected, the RMB has weakened almost all the way back to its lows just after August's mini-devaluation (see "On the RMB Devaluation" August 11, 2015). We stand by our call that the RMB depreciation will continue, and see the RMB's accession to the IMF's Special Drawing Rights basket as facilitating that, as the USD-peg becomes less important as a matter of global prestige.
- But we do expect weakness here -- in the macro numbers, and in US stocks. If oil makes a stand here, and recovers smartly, we've still got a chance of closing in the black for US equities for the year, making seven years in a row.
- Yet we know full well what it will take to make Yellen reverse "liftoff.' The same thing it took to make Trichet do it -- markets throwing a tantrum. We think it's just a question of how soon, and

how bad -- and the latter is a function of how quickly Yellen can swallow her rather enormous pride and do the right thing.

Bottom line

New lows for oil on no news for oil -- it probably means all the negatives are out, making what amounts to a double-bottom, and leaving only surprises on the upside. Yet there's a deflationary smell in the air, as "liftoff" approaches next week -- a mistake based on a misbegotten belief in the Phillips Curve. The Fed is ignoring that the back-up in credit spreads, accelerated by new agonies in the junk energy sector, is already the equivalent of thirteen rate hikes. Good news: long-term Treasury yields haven't budged, signaling that markets see the deflationary implications of a "liftoff" error. This supports equity valuations through equity risk premia. It is also good that the RMB continues to weaken, as we expected. These factors limit the depth of the tantrum that will make this rate hike "one-or-two and reversed."