



Assessing Bond Value in the New Era

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The post-pandemic shift in funding conditions could be shaping up to be as significant as those that defined the post-Global Financial Crisis (GFC) environment.

- Then – The GFC ushered in an era of collapsing household credit demand, surging savings rates, and a glut of excess capital. The result: 10 years of extremely low real interest rates, stable and low inflation, and a bull market in bonds driven by falling real yields.
- Now – The pandemic ushered in massive new fiscal expansion, driven by government spending on various industrial strategies, greening the economy, and securing supply chains in an increasingly unstable multipolar world. And so far, the household savings rate is half the level that existed pre-pandemic. The result: rising real interest rates. And yet, the 10-year breakeven inflation rate is only about 60 basis points higher than 2019 as reported inflation continues tanking. Meanwhile, nominal yields are well over 200 basis points higher than their pre-pandemic level.

A new equilibrium for interest rates?

Some idea of where equilibrium might be for interest rates is important to gauge both the stringency of monetary policy as well as the value opportunity for bonds. For the Federal Reserve (Fed), pushing market rates higher than the unobservable R^* —the neutral rate—is repressive for the economy. For investors, bond yields tend to over- and under-shoot their equilibrium in harmony with the business cycle. A moving target during the best of times, the equilibrium rate is exceptionally difficult to quantify with any confidence under these current circumstances: uncertainty is too extreme; the range of factors that could affect the equilibrium rate structure is too extensive; and the range of opinions among academic experts, analysts, and investors is too dispersed. Fed Chair Powell echoed this sentiment during his speech in Jackson Hole last week. His fallback position remains keeping rates up, at least until conditions clarify.

Without reliable quantitative benchmarks, the only basis we have for assessing where rates are relative to their equilibrium is judgment: that is, judging how markets and the economy are responding to the rate structure, which is the source of the current conundrum. Rates look high from a variety of perspectives. Yet, the US economy looks relatively resilient compared to Europe, which seems to have slipped into recession, and China, which is on the edge of systemic deflation—all suggesting the US equilibrium level of rates might be higher than most think. Complicating the judgment is the knowledge that the effects of tighter monetary policy play out with a long and variable lag, which could mean the opposite—namely that market rates are above equilibrium, and the recession many are forecasting is in the pipeline but not yet realized.

Judgment one: Rates are very high, and US monetary policy is already very stringent.

Exhibit 1 shows the fed funds upper target rate minus the Federal Reserve Bank of Atlanta's calculation for the stickiest part of the CPI basket less shelter, annualized over the past three months. The Fed has acknowledged that shelter inflation lags overall CPI and should retreat based on market measures. For example, the Federal Reserve Bank of San Francisco published a baseline forecast of shelter inflation that reaches zero by April next year and could be negative later in 2024.¹ The chart shows this short-term real interest rate metric at 4.5%, a level near previous tops over the past 50 years, except for the early 1980s. This metric does not include any consideration for the contraction in the Fed's balance sheet, which according to the

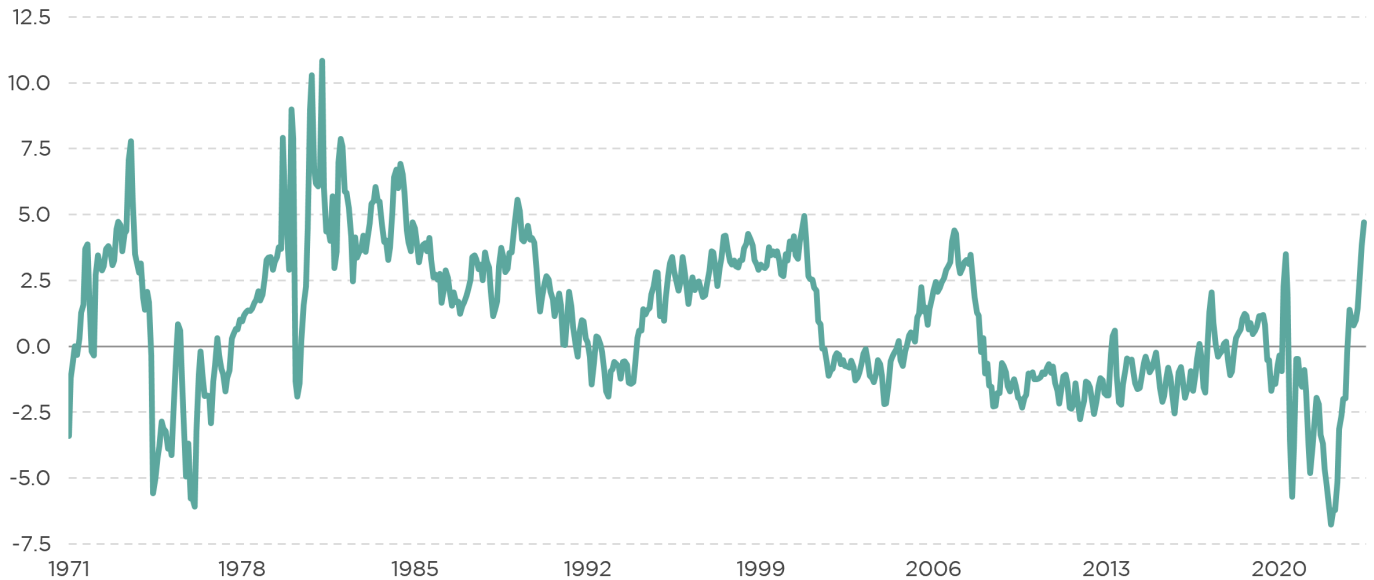
San Francisco Fed's proxy funds rate would be equivalent to another 184 basis points.

This impression of *extreme* monetary restrictiveness is consistent with the yield curve, the collapse in money growth, the plunge in housing affordability, stagnant private credit conditions, and zero growth in commercial bank lending. We also have had banking stress, although Fed intervention has prevented this from mushrooming into a full-blown credit contraction.

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Federal Funds Target Rate Minus Sticky Price CPI (ex. Shelter)

%, Fed funds rate - Atlanta Fed Sticky Price CPI (ex. shelter) (3-month), annualized rate, as of 8/23/2023



Source: Macrobond

The Federal Reserve Bank of Atlanta's Sticky Price Consumer Price Index (CPI) is calculated from a subset of goods and services included in the CPI that change price relatively infrequently. Because these goods and services change price relatively infrequently, they are thought to incorporate expectations about future inflation to a greater degree than prices that change on a more frequent basis. One possible explanation for sticky prices could be the costs firms incur when changing price.

Short-term interest rates appear very high, even by the standards of Larry Summers, famed American economist and former Secretary of the Treasury, who is well known for his view that R^* has shifted meaningfully higher post-pandemic, compared with the 10 years following the GFC. Summers believes that the neutral short-term rate, or R^* , might be close to 4%, based on assumptions of a 2.5% inflation rate and a real interest rate of 1.5%.² The Fed's current operating assumption, evidenced in its latest economic projections, is that R^* is closer to 2.5%.

Judgment two: US fiscal policy is the main reason why the domestic economy is more robust than would be expected with stringent monetary policy.

US fiscal policy is probably the main reason why the broad economic data domestically remain robust despite considerable weakness in the global economy and stringent Fed monetary policy.

In our view, US macro policy currently has one foot on the brakes and one foot on the gas pedal. Monetary policy is stringent, but fiscal policy has been very expansionary. Normally counter-cyclical, the budget deficit usually swells during recession and shrinks during expansion. This time, however, it has been the reverse.

President Biden has been extremely successful in passing big spending initiatives, including the Inflation Reduction Act and the CHIPS and Science Act. Despite strong domestic economic conditions, the current federal budget deficit has increased by

3.9% of gross domestic product (GDP) since early 2022 to nearly 7%, based on my calculations. The deficit was roughly 5.4% of GDP before the pandemic with employment levels lower and the unemployment rate higher. There has never been as large an expansion in the deficit before a recession or with the unemployment rate as low as it is currently. Assessing the multiplier and lagged effects from this stimulus is challenging, but the scale of the stimulus is clearly substantial. Federal government revenues are down significantly from their pandemic peaks relative to GDP but still well above levels seen in 2019. Total spending is over 2% points higher relative to GDP than pre-pandemic or \$2.1 trillion higher and over 1% higher, excluding interest payments.

The effect from a macroeconomic configuration of tight money and easy fiscal policy is well established: high real interest rates, strong economy and equity market, and a strong/firm dollar. The best example of this pattern was during the early 1980s under Reaganomics. A less extreme example came with the Trump administration's Tax Cuts and Jobs Act of 2017. The current environment seems to be the latest example.

Judgment three: Fiscal and monetary policy lags should slow nominal US activity significantly over the next year.

The positive impulse from fiscal stimulus fades with time unless the primary deficit continues to expand. Politicians do not care about the cost of money but pressure to resist bigger deficits is bound to start growing following the recent downgrade of US sovereign debt. Fiscal room to maneuver has collapsed given the revolt in the bond market and the most recent monthly data that show government spending on interest payments catching up quickly to spending on national defense. If the drive for a minimum global corporate tax is any indication, new fiscal initiatives out of Washington from the current administration will be about higher taxes.

Continued post-pandemic normalization will also be important. Any pickup in the savings rate following depletion of the excess savings accumulated during the pandemic from the fiscal handouts would be very bond friendly. Similarly, the resumption of student loan payments removes another fiscal prop supporting the economy and real yields.

In the meantime, the lagged effects of tight monetary policy are about to kick in just as the lagged effects of fiscal stimulus may be starting to fade. A shift to stringent monetary policy normally takes 18-30 months to fully play out. Inflation is normally the last thing to react to tight money, which would imply that most of the inflation gains realized so far have little to do with stringent money and more to do with improving supply chains. Under these circumstances, inflation could fall much further than most expect.

Recession? No recession? It is hard to say. While the yield curve is inverted, it is unusual for the US economy to fall into recession without a spike in energy prices. The latter have been in retreat since mid-2022, until the recent bounce beginning July. The clearest bet is for a big swoon in nominal economic activity.

Bottom line: Backdrop for the bond market has improved significantly.

Real interest rates are very high, and inflation is on a fast track lower. A fading fiscal policy impulse, the lagged effects of tight money kicking in over the next year, and more post-pandemic normalization of special factors ought to be the catalysts for some bond market mean reversion. We never thought a recession would be necessary if inflation normalized and the Fed pivoted in time to avoid a crunch. While the rate mantra for many is higher for longer, we think a mantra of lower for longer applies to inflation. How all these variables play out ahead is less clear with the interference coming from government spending. Equilibrium interest rate levels in the post-pandemic era could be higher than the post-GFC regime, but current market rates already seem extremely high. Furthermore, we expect the pace of *nominal* activity to slow significantly over the next year. Given this outlook, we believe the risk/reward profile favors the bond market. While the scale and timing of meaningful mean reversion lower in bond yields is unclear, the risk of even higher yields at this stage seems dramatically reduced.

¹ Augustus Kmetz, Schuyler Louie and John Mondragon "Where is Shelter Inflation Headed?", FRBSF Economic Letter, August 7, 2023. Federal Reserve Bank of San Francisco
<https://www.frbsf.org/economic-research/publications/economic-letter/2023/august/where-is-shelter-inflation-headed/>

² Presentation made by Larry Summers at the Peterson Institute for International Economics May 30, 2023, on the topic of “Rethinking fiscal policy-global perspectives”.

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