MV CAPITAL MANAGEMENT

Weekly Market Flash

The Fed and the Spread

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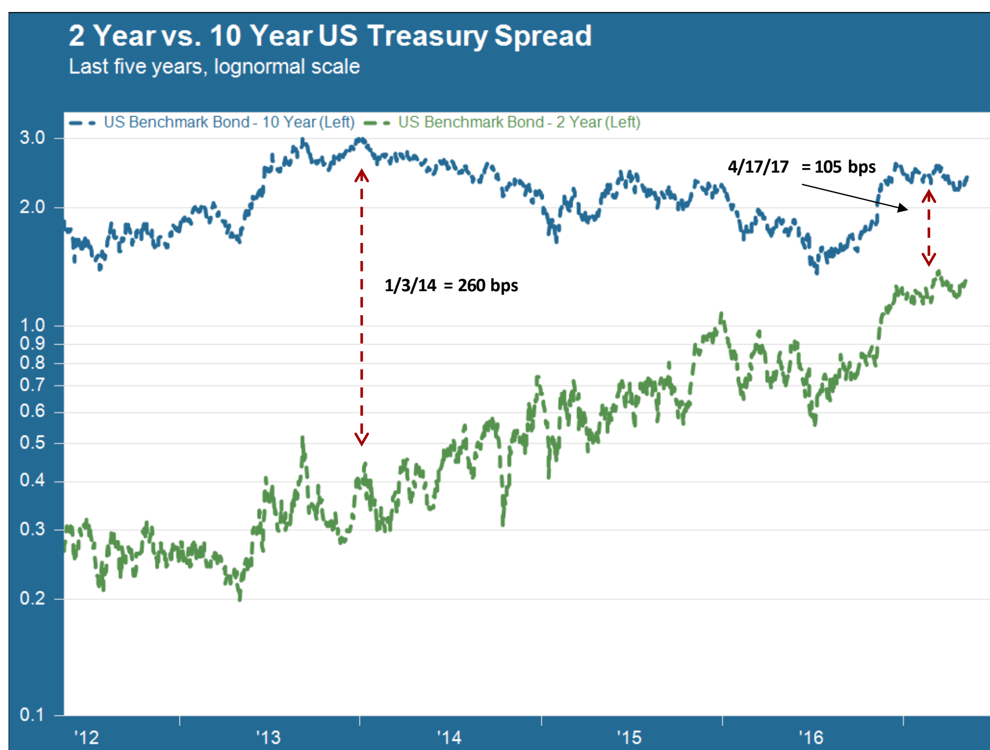
Three years ago, one could have driven a fleet of semitrailers through the open space between the 2 year and the 10 year US Treasury benchmark note yields. While there still is some distance between the two, it would be somewhat more amenable to a single row of Priuses (Prii?) passing through. As the chart below shows, the shorter term note, which is generally more directly responsive to Fed policy, remains very close to its five year high. The intermediate 10 year yield, by contrast, has meandered along a largely directionless trajectory.



Source: MVF Research, FactSet

Untangling Policy, Demand and Expectations

The path of shorter term yields, for which the 2 year note is a useful proxy, is not hard to understand. The Fed began to make noises about tapering its QE policy in 2013 and then moved to a regime of reasonably explicit forward guidance on rates in 2015, resulting in the first increase at the end of that year. Despite falling sharply during the turmoil of early 2016, the 2 year resumed its upward path as conditions settled down and the case for a steady, if not spectacular, pace of economic recovery settled in as the default narrative. One should expect short term yields to continue tracking upwards in the absence of a reversal of the Fed's stated intentions to keep raising rates.

For much of this time, the 10 year benchmark marched to a different drummer. Foreign demand was a key determinant of the consistently subdued yields experienced over this time – a trend that confounded no small number of bond pros. Rather than breaching 3 percent, as many expected, the 10 year actually set an all-time low – as in "since the founding of the American Republic all-time low" – in the immediate aftermath of Brexit.

The November election and the emergence of the so-called "reflation trade" brought about a shift in expectations, such that both intermediate and short yields moved largely in tandem. This was, as you will recall, when the

prevailing mindset among investors imagined dramatic changes to the tax code and a sweeping new program of public spending on infrastructure. The spread between the 10 year and the 2 year in the weeks leading up to the election was mostly below 100 basis points, and it has not strayed very far from that level since.

Mind the Gap

The question now, of course, is whether there is still enough oomph in those reflationary expectations to send the 10 year into higher territory with a resulting steepening of the curve. This would be the putatively logical case to make for one who still believes there's an infrastructure/tax reform pony out back with the capability to deliver the economic growth bump (however short-lived that might be) that is the administration's central economic talking point. This view would consider the recent string of so-so hard data releases (including today's six-of-one-half-dozen-of-the-other retail sales and inflation results) to be temporary and primed for near-term growth.

On the other hand, if the gap narrows still further – if the spread falls back into double digits as short term rates inch up while intermediates hold steady or fall again – investor brains could fall prey to the dark sentiments of an flat or inverted yield curve. That outcome would likely serve as a validation for those opining that bond yields represented the "smart view" while equity valuations soared on little more than a wing and a prayer.

The $4.5 Trillion Dollar Question

In the midst of all this is one very important and highly unpredictable variable: when and how the Fed plans to begin drawing down the $4.5 trillion balance sheet it racked up over the course of three quantitative easing programs. Observers will pay closer than usual attention to the forthcoming release of the FOMC's minutes (scheduled for May 24) from its most recent policy meeting, scouring the language for clues about their intentions. The conventional wisdom is that the Fed believes there will eventually come a time when it needs to take rates back to zero and possibly launch another bout of QE. Having the dry powder to launch such a plan will necessitate a meaningful balance sheet reduction in the meantime. The tricky part, of course, will be to pull of this maneuver without roiling asset markets in so doing. Given the preternatural calm prevailing in risk asset markets currently, any hiccup could turn into a negative catalyst. Fed members will need to be practicing their triple-axel techniques to pull this off.

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