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fxPoetry

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Yield Hawks Reappear

The market is starting to fear
Inflation is soon coming here
So, tech stocks got hammered
But nobody clamored
For bonds as yield hawks reappear

European markets are having a tough day as it appears investors want nothing to do with either stocks or bonds and only commodities have seen any demand. Apparently, despite a strong desire for higher inflation, the ECB is not enamored of higher bond yields. This was made abundantly clear yesterday when Madame Lagarde explained the ECB is "closely monitoring" the government bond market, with a special emphasis on German bunds. Clearly, this was prompted by the fact that 10-year bund yields have risen nearly 25 basis points in less than a month, similar to the rise in 10-year Treasury yields and are now well above the ECB's deposit rate. As Banque de France Governor Villeroy noted, the ECB will ensure financing conditions remain favorable, and seemingly, -0.306% 10-year yields have been determined to be too tight.

This is a perfect indication of the difficulty that the central banks have brought upon themselves by constantly easing monetary policy into every market hiccup and then getting upset when investors don't obey their every wish. After all, if the underlying problem in Europe is that inflation is too low (a story they have been pushing for more than a decade) then one would think that rising bond yields, signaling rising inflation expectations would be a welcome sight. Of course, the flaw is that rising bond yields often lead to declining share prices, something that apparently no major central bank can countenance. Thus, the conundrum. Essentially central banks want higher inflation but simultaneous low yields and high stock prices. That's not so much a goldilocks scenario as a Dungeons and Dragons fantasy where they are the Dungeon Master. In other words, it cannot occur in the real world, at least for any extended period of time.

Hence, the comments by Lagarde and Villeroy, and the great expectations for those from Chairman Powell later this morning. Exactly what can the central banking community do to achieve their desired goals? Markets are beginning to question the narrative of central bank omnipotence, and those central banks are starting to fear that they will lose control over the situation. As I have written before, at some point, the Fed, or ECB or some other central bank will implement some new program and the market will ignore it and continue on its merry way. And when that is happening, that 'way' will be down. At the end of the day, while central banks have shown they have extraordinary power to sway markets, they are not bigger than markets.

Back in the 1990's, the term bond vigilantes was quite popular as a description of bond market traders who responded negatively to budget deficits and drove yields higher and stocks lower accordingly, thus keeping government spending in line. In fact, that was the last time the US ran budget surpluses. With the proposed $1.9 trillion stimulus bill still seemingly on its way, it is entirely possible that those long-dead vigilantes may be rising from the grave. Back then, the Maestro would never consider capping yields or QE as a response, but the world is a different place today. If bonds continue to sell off further, the $64 billion question is, how will the Fed respond? It is this scenario, which could well be starting as we speak, that has brought the idea of YCC to the fore. We have already seen tech stocks begin to suffer, weighing heavily on major indices, and those other harbingers of froth, Bitcoin and Tesla, have reversed course lately as well. As I wrote last week, long tech stocks is like being short a Treasury bond put, as they will suffer greatly with higher yields. At what point will the Fed decide yields are high enough? Perhaps Chairman Powell will give us a hint today, but I doubt it.

Ahead of his testimony, here is what is happening in markets, where I would characterize things as inflation concerned rather than risk off. Bond markets in Europe, as mentioned, are selling off sharply, with Bunds (+4.1bps), OATs (+4.8bps) and Gilts (+4.0bps) all feeling the pain of rising inflation expectations. In fact, every country in Europe is seeing their bonds suffer today. Treasuries, at this hour, are relatively flat, but continue to hover at their highest level in a year. Interestingly, the first clue of central bank response came from Australia last night, where the RBA was far more aggressive buying the 10-year sector and pushed yields back down by 4.1bps. However, their YCC on the 3-year is still in trouble as yields there remain at 0.12%.

Equity markets are almost universally weaker in Europe (only Spain is showing life at +0.6% as a raft of holiday bookings by frustrated UK citizens has seen strength in the tourist sector of the economy). But otherwise, all red with the DAX (-1.1%) leading the way, followed by the FTSE 100 (-0.3%) and CAC (-0.2%). Asia was a bit of a different story, as the Hang Seng (+1.0%) managed to benefit from ongoing inflows from the mainland, although Shanghai (-0.2%) was more in line with the global story. The Nikkei was closed for the Emperor's birthday. As to US futures, tech stocks remain under pressure with NASDAQ futures lower by 1.5%, although SPU's are down by just 0.5%.

Commodities are where its at this morning, though, with oil, after a powerful rally yesterday, up another 0.7% and over $62/bbl for WTI now. Copper is up a further $200/ton and pushing to the all-time high of $9600/ton set back in 2010. With all the talk of the elimination of combustion engine vehicles, it turns out EV's need 3 times as much copper, hence the demand boost. Meanwhile, the rest of the base metals are also performing well although precious metals are little changed on the day. Of course, gold at flat is a lot better off than Bitcoin, which is down more than 16% on the day.

And lastly, the dollar, is having a mixed session. The pound is the leading gainer, +0.2%, as plans for the reopening of the economy as the vaccine rate continues to lead the G10, has investors looking on the bright side of everything. On the flip side, CHF (-0.45%) is the laggard

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on what appear to be market technical movements as price action has taken USDCHF above the top of a downtrend channel. Otherwise, the G10 space is showing little movement in either direction.

As to emerging market currencies, after some terrible performances yesterday, BRL (+0.3%) and MXN (+0.3%) are opening firmer on a rebound along with CLP (+0.4%) following Copper prices higher. However, the rest of the bloc is +/-0.2% which is the same thing as unchanged in this context.

On the data front, yesterday saw Leading Indicators a touch better than expected and two lesser followed Fed regional indices print strongly. This morning Case Shiller home prices (exp 9.90%) and Consumer Confidence (90.0) are the highlights, neither of which is that high. In fact, the true highlight comes at 10:00 when Chairman Powell testifies to the Senate Banking Committee. It will be interesting to see if he touches on the recent rise in yields, especially expressing concern over their movement. But more likely, in my view, is that he will simply agree that more fiscal stimulus is critical for the economy and that the Fed will continue to support the economy until "substantial further progress" is made on their objectives.

Adding it all up tells me that risk is going to continue under pressure for now, although given the magnitude of the move we have seen in bond yields, it would not be surprising to see them consolidate or reverse for a while in a trading correction. As to the dollar, higher yields ought to prevent any sharp declines, but it still looks like we have seen the extent of the correction already and it will continue to trade in its recent range.

Good luck and stay safe
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