

This Fed is not for moving

Chair Powell remains on a mission to reach the hardest hit communities. That's more important than inflation at 5%. Fair enough. Taper talk is nuanced in consequence. Bond buying is adding a liquidity excess that is bullying market rates to extraordinary lows, practically into submission. It looks too much and should be unwound, but not just yet it seems



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The Fed remains ultra easy, to help reach communities that have been hardest hit by the pandemic.

Chair Powell, before the House Finance Committee, is not for changing. Two things are still “a ways off”. One is “substantial further progress” and the other is the timing of the taper of bond purchases. On the first element, a key barometer is employment, which remains well below pre-pandemic levels. The second element depends on the first, and bottom line the Federal Reserve remains on an ultra-easing path, to help reach communities that have been hardest hit by the

pandemic.

On the risks, Chair Powell acknowledges that inflation is significantly above 2%. But the key thing is where it lands in the coming 6-12 months, and for now the Fed has reasonable confidence that it will be far closer to 2% by the end of that time frame. On housing, the explanation for the rapid rise in prices is on changes in preferences and materials shortages, and not driven by reckless financing. Chair Powell is clearly distancing the Fed from any blame here, but with some justification.

The bond market couldn't care less, it seems.

The bond market couldn't care less, it seems. Maybe just listening super carefully, but could be sleeping too. Having come through further confirmation of outbreaks in consumer and producer price inflation to the upside in the past 24 hours, and little appetite for a sub-2% 30yr bond auction, yields are practically unchanged, as if nothing has happened. Just like Chair Powell, this bond market too is not for changing.

In the meantime, despite the reluctance of demand at sub-2% at yesterday's 30yr bond auction, the yield is now in fact now back below 2%. And the 10yr is back below 1.4%. The 5yr is bang on neutral between the 2yr and 10yr, giving nothing away. And the 2yr is back below 25bp. The latter, in particular, is not anticipating material rate hikes in the coming 2 years. The key question is whether this is actually discounting anything, or whether it just reflects an excess demand for bonds.

In effect the Fed has been financing that deficit, fully.

The latter in part comes from the Fed's bond buying programme. It's not just the ongoing USD120bn per month, it is the cumulative effect of this, as it has summed to circa USD3trn since the pandemic first hit. The size of the 2020 fiscal deficit was in fact USD3trn. In effect the Fed has been financing that deficit, fully. In addition the buying continues, while at the same time there is some USD800bn getting shipped back to the Fed at 5bp on the overnight reverse repo facility.

There is a clear technical rationale for the Fed to ease up on the bond buying programme.

So there is an excess of liquidity, or at least liquidity that goes back to the Fed as there are few viable alternatives on the front end to 5bp on the overnight. This compression of front end rates is being driven by the liquidity excess. From this there is a clear technical rationale for the Fed to ease up on the bond buying programme. Moreover, it can be argued that the Fed bond buying

programme is messing up the back end too, keeping longer term yields too low versus macro fair value.

With inflation at 5% versus a yield curve that peaks at 2% on the 30yr, there is a clear deviation that must be telling us something. The implied negative real yields are either saying that the macro outlook is very somber. Or it's telling us that there is an artificial excess of demand. It's not all coming from the Fed but if the Fed is on the buy side of the trade there is a clear incentive for other players to be on the same side. An accelerated taper would change that dynamic.

Should the Fed taper at all? Why not just stop the buying? The macro target dominates, that's why

From Chair Powell's testimony, there is no indication that the taper chat is any more elevated than it was at the mid-June FOMC meeting. There is a lot to be said in support of a much quicker taper than anticipated. It needs to go from USD120bn of bond buying per month to zero per month. From a purely technical perspective there should be no taper, and the Fed should just stop buying. But from the perspective of a "hardest hit community" focus, that won't happen.

So expect the liquidity excesses on front end rates and downward pressure on back end rates from this perspective to remain a dominating influence, especially if this bond market chooses to completely ignore where inflation prints.

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