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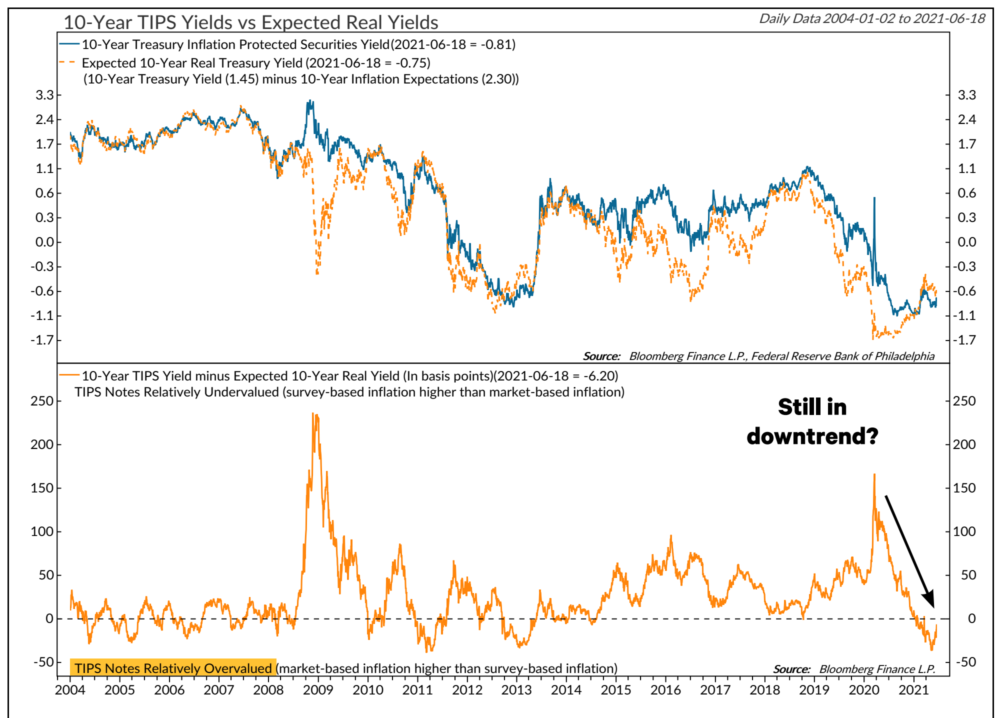
email us

# Fed blinks, now what?

## Key Takeaways

- TIPS are overvalued and on downgrade watch.
- Violent flattening of the yield curve could force steepening trade closure.
- Curve could re-steepen in the coming months.

## TIPS at risk of downgrade

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Although most economists (us included) were looking for more participants to shift their first rate hike to 2023 from 2024 and beyond, the markets were not prepared for a median of two rate hikes in 2023.

## TIPS on downgrade watch

Real yields rose (especially on the short end) and inflation expectations declined. TIPS, which we have been saying were relatively overvalued for the past few months, became less overvalued, as their attractiveness waned.

In last week's Outlook, we cautioned that TIPS were vulnerable to a downgrade in the second half of the year.

As shown in the bottom clip of the chart above, the downtrend in the relative value line has not yet decisively broken to the upside. So we continue to watch the relationship. A sustained move above zero would likely do the trick, prompting a TIPS downgrade from its current overweight position.

## Flatter curve

In our write-up following the meeting, we were looking for an immediate flattening of the curve. With rate hikes being pulled forward and participants seemingly more concerned about inflation, short-term rates rose and long-term yields declined, resulting in a violent flattening of the yield curve. But we haven't yet pulled the plug on the steepener trade either. Although all of our models deteriorated, half remain in the steepening mode.

## Re-steepen?

We also think the curve could re-steepen in the coming months.

First, **supply will increase**, as the Treasury General Account returns to more normal levels.

## Persistent inflation?

Second, inflation could be persistently above the Fed's 2% target. Although we agree that current inflationary pressures are largely transitory and that bottlenecks will be resolved in six to twelve months, it will be replaced by items that are more persistent and sticky, particularly housing. Shelter costs have climbed back above 2% y/y, mostly on a rebound in lodging.

But **rents are skyrocketing** too, as eviction moratoriums end and people move back to the cities as offices reopen. U.S. rents rose last month, accelerating 2.3% in May from 1.3% in April, the largest monthly gain since 2015, according to Zillow. Rents were up 5.4% from a year earlier, and were especially strong in the Inland West.

We believe annual shelter costs are heading back to pre-pandemic levels around 3.5%.

## Rebirth of Phillips curve?

Additionally, the Phillips curve has been totally discredited since the GFC. Yet, labor markets appear tight and wages are going up. The bigger risk is if **the Phillips curve reasserts itself**.

## FOMC composition change

As we discussed previously, the composition of the FOMC will change to one that is likely to be less hawkish, which could delay rate hikes.

## The Fed's new conundrum

A final risk for the Fed that I call **the Fed's New Conundrum** is if inflation and inflation expectations stay above target before maximum employment is achieved.

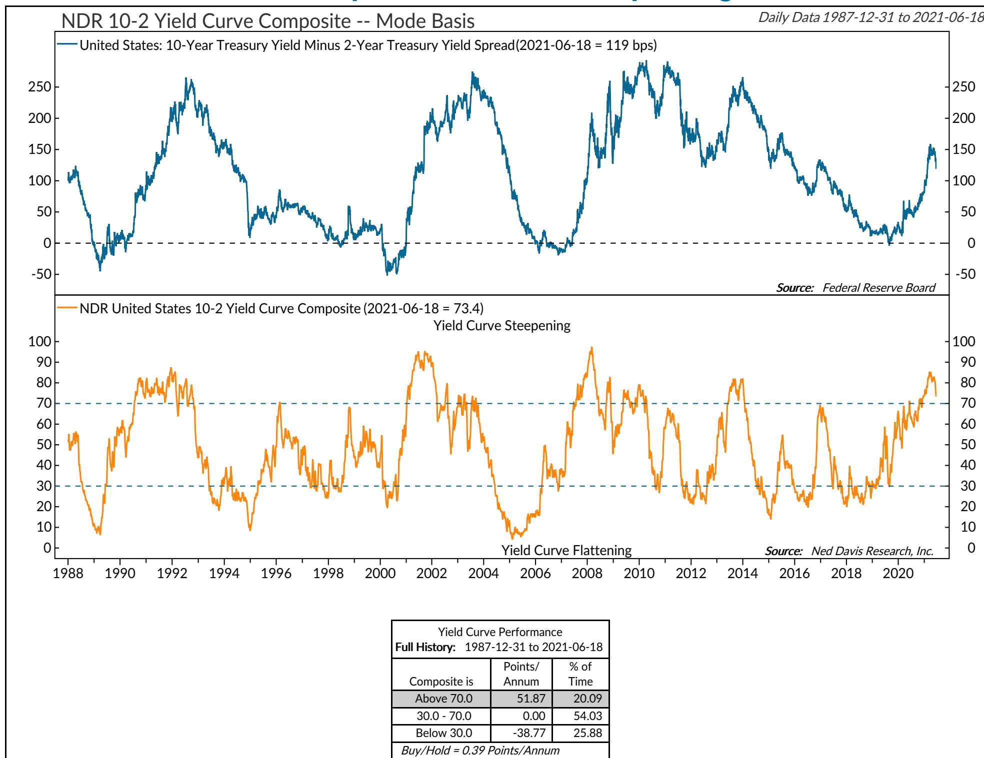
The new Statement on Longer-Run Goals and Monetary Policy Strategy says that when the employment and inflation objectives are not complementary, the FOMC will take into account "the employment shortfalls and inflation deviations and the potentially different time horizons over which employment and inflation are projected to return to levels judged consistent with its mandate."

It took several years to reach maximum employment in the last cycle. They could continue to be patient. In addition, the inflation deviations may not be large enough to stand in the way of achieving maximum employment.

**If the Fed doesn't hike rates, the market will do it for them.**

The benchmark 10-2 model (below) remains in the steepening mode, along with two other curve models. To view all yield curve models see report BMS_15.

## Benchmark 10-2 is in uptrend and in steepening mode




Yield Curve Performance
Full History: 1987-12-31 to 2021-06-18

| Composite is | Points/ Annum | % of Time |
|---|---|---|
| Above 70.0 | 51.87 | 20.09 |
| 30.0 - 70.0 | 0.00 | 54.03 |
| Below 30.0 | -38.77 | 25.88 |

*Buy/Hold = 0.39 Points/Annum*

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# NDR HOUSE VIEWS (Updated June 3 , 2021)

NDR recommends maximum overweight allocation to equities, underweight allocation to bonds and marketweight allocation to cash. It is likely that we have seen a reset of the secular bull market that started in 2009.

## Equity Allocation

**U.S. |** We are marketweight the U.S. relative to other regions but are bullish on an absolute basis. The rally from the March 23 low has met the NDR criteria for a cyclical bull market, and we are shifting to risk-on assets as models confirm. We favor small-caps over large-caps and Value over Growth.

**INTERNATIONAL |** We are overweight Europe ex. U.K., underweight U.K. and Pacific ex. Japan, and neutral on all other regions within our seven-way regional allocation framework.

## Macro

**ECONOMY |** The global economy fell into its deepest recession in the postwar era due to COVID-19, but pent-up demand and robust stimulus is setting the stage for a strong rebound in growth in 2021. Inflation will jump in the short-term, but long-term trends are anchored.

**FIXED INCOME |** We are 85% of benchmark duration. We are positioned for a steeper yield curve. We are overweight MBS, ABS, HY corporates, EM, and TIPS. We are underweight Treasurys.

**GOLD |** Long-term uptrend intact. We are bullish.

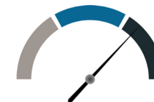
**DOLLAR |** Our long-term technical composite is negative. We are bearish.

## Economic Summary

June 21, 2021

Near term activity: ● Accelerating ● Neutral ● Decelerating

Global Economy (6.1%)



U.S. Economy (6.5%-7.0%)

U.S. Inflation (2.5%-3.0%)

Economic gauges reflect changes in near-term economic activity. Numbers in parenthesis refer to NDR 2021 forecasts.

## Global Asset Allocation

● Overweight ● Marketweight ● Underweight

- ● Stocks (70%)
- ● Cash (10%)
- ● Bonds (20%)

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

### Equities — Regional Relative Allocation

- ● Europe ex. U.K. (17%)
- ● U.S. (57%) | Emerging Markets (13%) | Japan (6%) | Canada (3%)
- ● U.K. (2%) | Pacific ex. Japan (2%)

Benchmark – U.S. (57.9%), Europe ex. U.K. (13%), Emerging Markets (12.9%), Japan (6.7%), U.K. (3.7%), Pacific ex. Japan (3.1%), Canada (2.8%)

### Global Bond Allocation

- ●
- ● U.S. (50%) | Europe (28%) | Japan (17%) | U.K. (5%)
- ●

Benchmark: U.S. (50%), Europe (28%), Japan (16%), U.K. (6%)

## U.S. Allocation

- ● Stocks (70%) | Small-Cap | Value
- ● Mid-Cap | Cash (10%)
- ● Bonds (20%) | Large-Cap | Growth

Benchmark: Stocks (55%), Bonds (35%), Cash (10%)

### Sectors

- ● Financials (13%) | Industrials (12%) | Energy (4%)
- ● Technology (24%) | Consumer Staples (5%)

Benchmark: Technology (27.0%), Health Care (13.5%), Financials (10.0%), Communication Services (11.1%), Consumer Discretionary (12.5%), Consumer Staples (7.3%), Industrials (8.3%), Energy (2.4%), Utilities (2.8%), Real Estate (2.5%), Materials (2.6%)

### U.S. Bonds — 85% of Benchmark Duration


Please see important disclosures at the end of this report.

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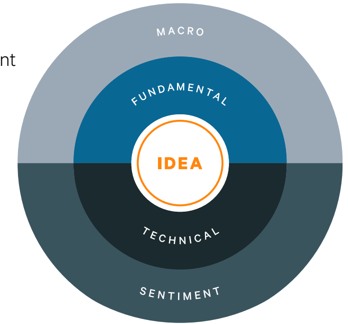


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