FIXED INCOME

“We tend to use [transitory] to mean that it won’t leave a permanent mark in the form of higher inflation. I think it’s probably a good time to retire that word and try to explain more clearly what we mean.”

- Federal Reserve Chair Jerome Powell before the US Senate Committee on Banking, Housing, and Urban Affairs, November 30, 2021

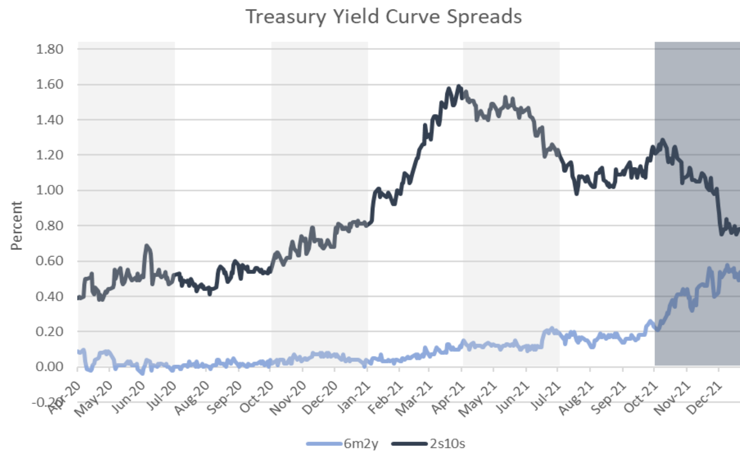
In response to a question from Pennsylvania Senator Pat Toomey during Senate hearings on coronavirus and the CARES Act, Chair Powell confirmed that the central bank’s 2 percent average inflation test had been met, and that describing above target inflation as “transitory” – implying short lived – was no longer viewed as helpful or accurate.

The fact that inflation was higher and likely to be more persistent than previously expected didn’t surprise the market, which had taken recent inflation data at face value. The consumer price index (CPI) saw year-over-year increases of 6.2 percent, 6.8 percent, and 7.0 percent for the three months in Q4. But Powell’s recognition of this fact was an inflection point for the market as it confirmed that policymakers were no longer waiting for a supply side response to relieve price pressures. The market’s repositioning around these historic inflation prints, and more hawkish Fed posture was the defining feature for bond markets during the quarter.

Source: US Department of the Treasury

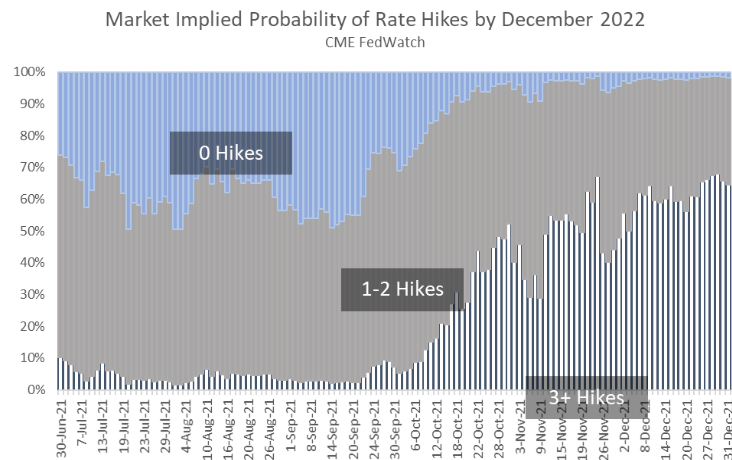
Given the significance of these events, it is perhaps surprising that the 10-year finished the fourth quarter exactly where it started. The level of the curve didn’t signify much about the bond market during the period. The story was in the relationship between real and nominal rates, the shape of the yield curve, and what the short-term rate market was discounting.

The five-year breakeven inflation rate topped out in mid-November, having risen by 66 bps to 3.17 percent, and would retrace about half that move by year end, as investors began to internalize the inflation-suppressing priorities of the Fed. The real action, though, was in shorter maturities, as the 2-year nominal bond yield jumped 45 bps.



Source: US Department of the Treasury

The flattening of the yield curve caught many investors off guard, having been positioned for more persistent inflation that would trigger a sell-off in long bonds. Instead, they got a 30-year yield declining 18 bps to 1.90 percent. Lastly, the market implied probability of no hikes during 2022 fell from 25 percent to 2 percent during the fourth quarter, while three or more hikes became consensus (65 percent probability) after carrying odds of just 7/100 coming into the quarter.



Source: CME

All this is to say that the market is pricing for Fed action to be effective in curbing inflation. And for the vocal Fed critics, the market is offering an opportunity to follow the old saying “put your money where your mouth is.”

Following the January 4 release of the minutes from the December FOMC meeting, the bond market has seen more widespread bearishness as expectations for quantitative tightening (QT) come into focus with “almost all” Fed decision-makers supporting balance sheet reduction. The market has clearly been shaken by the taper-hike-QT hopscotch. The market tends to overreact during these transitional periods, while policymakers will be proceeding to tighten as indicated until there is some hint of inflation normalization (the January 12 CPI print failed to suggest that). Bond buyers be warned.