



MORNING BRIEFING

July 20, 2021

Bond Conundrum Explained

Check out the accompanying [chart collection](#).

(1) A year of bond-market conundrums. (2) An old stock-market adage applies to the bond market now too. (3) Bond yields fall despite four months of higher-than-expected CPI inflation. (4) Powell's four pandemic-related reasons not to rush to tighten. (5) The next inflationary shock likely to be in wages. (6) A few bearish indicators for bonds. (7) Fed's bullish impact on bonds amplified by flood of deposits commercial banks forced to invest in bonds. (8) OPEC+ deal greases bond yields' slippery slope. (9) Powell vs Greenspan conundrums.

Bonds I: Don't Fight the Fed Chair. Almost everyone has been puzzled by the bond-market conundrum. This year, we've been writing about it since the March 1 [Morning Briefing](#). At the time, we observed, "Powell's conundrum is that bond yields are soaring despite his best efforts to keep a lid on them by buying all of the notes and bonds issued by the Treasury, and more, since early last year." Apparently, he solved that problem, and now the conundrum faced by bond bears is why bond yields have subsequently plunged notwithstanding lots of evidence of an inflationary economic boom.

The 10-year US Treasury bond yield bottomed last year at 0.52% on August 4 ([Fig. 1](#)). It rose to 0.93% by the end of last year. It continued to rise earlier this year. Everyone seemed to agree that it would likely rise to 2.00% by the end of this year. Instead, the yield peaked at 1.74% on March 31, and has been falling ever since then to 1.19% yesterday, the lowest since February 11.

The consensus bearish outlook for the bond market seemed to make sense given that the ongoing V-shaped recovery in US economic activity has started to put upward pressure on inflation in recent months.

However, the bond yield fell notwithstanding higher-than-expected increases in the headline CPI for March (2.6% y/y), April (4.2), May (5.0), and June (5.4). The simplest explanation for this conundrum can be found in the old adage "Don't fight the Fed." In the past, it has been mostly applied to the stock market, rarely to the bond market. This time, it has been very relevant to both. Its relevance to the bond market has been heightened by the Fed's massive purchases of notes and bonds since the Fed announced QE4ever on March 23,

2020 ([Fig. 2](#)).

That still leaves a conundrum to explain. The bond yield rose from August through March despite QE4ever purchases. It did so on expectations that Covid vaccines would end the pandemic, boost economic growth and inflation, and cause the Fed to taper its purchases and hike the federal funds rate. The yield-curve spread between the 10-year bond yield and the federal funds rate widened from -60bps on March 3 last year to a recent peak of 161bps on March 31 this year ([Fig. 3](#)). In the past, such a steepening of the yield curve tended to occur when the economy was recovering from a recession and was heading toward an expansion ([Fig. 4](#)).

So what happened this time? Why is the yield-curve spread back down to 118bps, the lowest since February 18?

The adage should be updated for the times to “Don’t fight the Fed chair.” Fed Chair Jerome Powell has been fighting market expectations that the Fed will be tightening monetary policy sooner rather than later. He has been winning the tug of war with the bond market. He has recently been assisted by the Delta variant of Covid-19. If Powell has his way, the recent spread of the variant in the US decreases the odds that the Fed will start tapering its bond purchases sooner rather than later.

That’s because Powell’s list of reasons to hold off on tightening monetary policy includes the pace of progress in dealing with the pandemic. Consider the following:

(1) *Slowing vaccination pace*. In his June 16 [press conference](#), Powell said, “The pandemic continues to pose risks to the economic outlook. Progress on vaccinations has limited the spread of COVID-19 and will likely continue to reduce the effects of the public health crisis on the economy. However, the pace of vaccinations has slowed, and new strains of the virus remain a risk. Continued progress on vaccinations will support a return to more normal economic conditions.”

(2) *BEABTI*. Powell also said that the rebound in inflation was likely a transitory consequence of the pandemic: “So inflation has come in above expectations over the last few months. But if you look behind the headline numbers, you’ll see that the incoming data are ... consistent with the view that [the] prices ... driving that higher inflation are from categories that are being directly affected by the recovery from the pandemic and the reopening of the economy.”

Powell has been the number-one proponent of “BEABTI,” which stands for the “base-effect-and-bottleneck theory of inflation.” That’s his interpretation of recent inflationary pressures. In his opinion, they mostly reflect rebounds in prices that were depressed a year ago by the lockdowns and temporary supply bottlenecks resulting from a surge in demand as the economy has reopened.

(3) *On inflationary expectations.* Powell also said that the rebound in inflationary expectations over the past year was actually a relief: “It’s gratifying to see them having moved up off of their pandemic lows.”

(4) *Delta variant.* In his presser, Powell raised the issue of the Delta variant as follows: “What you’ve seen with the pandemic is sharply declining cases, hospitalizations, and deaths. And that’s great. And ... that should continue. But you also saw in the United Kingdom, which has, I think, at least as high if not higher vaccination rates, they’ve had an outbreak of the Delta variety. And it’s causing them to have to react to that. So you’re not out of the woods at this point. And ... it would be premature to declare victory. Vaccination still has a ways to go ... It would be good to see it get to a substantially higher level.”

Bonds II: Tug of War. The action in the bond market yesterday suggested that Powell has won his tug of war with the bond bears, a.k.a. Bond Vigilantes. If they indeed have capitulated, then we may be getting close to the bottom of the downdraft in yields.

Nevertheless, for now, the tug of war continues between Powell’s BEABTI view of the world and the inflationary economic boom reflected in the latest batch of economic data. Debbie and I aren’t seeing much evidence of an imminent peak in inflationary pressures. On the contrary, we think that the next inflationary shock is likely to be in the average hourly earnings data released in the monthly Employment Report. While we are waiting for July’s data, which will be released on August 6, let’s assess the current strength of the forces on both sides of the tug of war:

(1) *Nominal GDP.* In the past, the bond yield has tended to trade in the same neighborhood as the yearly percent change in nominal GDP ([Fig. 5](#)). The spread between the two was mostly negative during the 1950s through the 1970s, when the Bond Vigilantes weren’t sufficiently vigilant about inflation ([Fig. 6](#)).

The spread turned mostly positive during the 1980s and 1990s, when the Bond Vigilantes were vigilant. The spread was most often slightly negative during the 2000s through today because there was less reason for the Bond Vigilantes to be vigilant against inflation.

In any event, according to this Bond Vigilante Model, with nominal GDP up 2.3% y/y during Q1-2021, the bond yield should be closer to 2.00% than to 1.00%. The Vigilantes are not being vigilant or they are being outgunned by the Fed. (See the excerpt from my 2018 book, [*"The Bond Vigilantes."*](#))

(2) Real yield. During Q1, the GDP deflator rose 1.98% y/y, resulting in a real bond yield of 1.32% ([*Fig. 7*](#) and [*Fig. 8*](#)). The CPI inflation rate was 5.39% y/y during June, putting the real bond yield at -3.87%, the lowest since June 1980 ([*Fig. 9*](#)). The TIPS yield was -1.05% yesterday. The yield on high-yield corporate bonds was down to 4.04% on Friday, below the CPI inflation rate for the first time on record ([*Fig. 10*](#)).

It's hard to come up with a good fundamental explanation for why real bond yields should be negative under the current economic circumstances.

(3) *Copper/gold ratio*. While the copper/gold price ratio continues to signal that the 10-year US Treasury bond yield should be over 2.00%, the gravitational pull of near-zero government bond yields in Germany and Japan may be another factor keeping the US yield down ([*Fig. 11*](#) and [*Fig. 12*](#)).

By the way, the reason that the copper/gold price ratio has tracked the bond yield so closely in the past is that the price of copper is very highly correlated with a proxy for expected inflation: the yield spread between the 10-year nominal bond and the comparable TIPS ([*Fig. 13*](#)). Meanwhile, the price of gold is highly correlated with the inverse of the 10-year TIPS yield. We like to think of the copper/gold price ratio as a risk-on versus risk-off indicator ([*Fig. 14*](#)). Notwithstanding the recent jump in inflation, the expected-inflation proxy edged down from a recent peak of 2.54% on May 17 to 2.33% on Friday.

(4) *Fed's ammo*. Since the start of the pandemic, the Fed has demonstrated that it has plenty of ammo left. The Fed has been purchasing \$120 billion per month in notes and bonds since late last year ([*Fig. 15*](#)). The bullish impact on the bond market has been amplified by the surge in demand deposits resulting from the Fed's purchases. At the same time, business loan demand has been weak because funds are available in the capital markets at record-low yields ([*Fig. 16*](#)). So banks have been forced to invest their deposit inflows in the bond market.

(5) *Oil*. Of course, yesterday's slide in the bond yield was also greased by the drop in oil prices. Oil prices plunged more than \$4 a barrel on Monday, after OPEC+ agreed to boost

output, stoking fears of a surplus as rising Covid-19 infections in many countries threaten demand.

Bonds III: Conundrums Now & Then. The current bond-market conundrum is somewhat reminiscent of the “Greenspan conundrum,” which I discussed in my 2020 book [*Fed Watching for Fun and Profit*](#). The federal funds rate was increased by 25 basis points to 1.25% at the June 29–30, 2004 meeting of the FOMC. That was followed by increases of 25 basis points at every one of the next 16 meetings, putting the rate at 5.25% after the June 29, 2006 meeting. It remained at that level through August 2007.

However, yields didn’t rise. Instead, the 10-year US Treasury bond yield fluctuated around 4.50% from 2001 to 2007. That was a big surprise given that short-term rates were almost certainly going to go up at every FOMC meeting, albeit at an incremental pace, once the Fed commenced its measured rate hikes.

Then-Fed Chair Alan Greenspan was puzzled. In his February 16, 2005 semiannual [*testimony*](#) to Congress on monetary policy, he said globalization might be expanding productive capacity around the world and moderating inflation. Nevertheless, he concluded, “For the moment, the broadly unanticipated behavior of world bond markets remains a conundrum.”

Then-Fed Governor Ben Bernanke tried to solve the conundrum in a March 10, 2005 [*speech*](#) titled “The Global Saving Glut and the U.S. Current Account Deficit.” He argued that the US bond market during the 2000s was increasingly driven by countries outside of the US. In his narrative, there was a “global savings glut.”

So the conundrum back then was that the Fed was tightening but the bond market didn’t follow the Fed’s lead. This time, the behavior of the bond yield makes more sense relative to the federal funds rate—which has been pegged at zero by the Fed since March 15, 2020—with Powell signaling that he is in no rush to raise it. The conundrum this time might be that the bond market is following the lead of the Fed chair when the data have convinced bond investors that an inflationary boom is underway and that the yield should be moving higher, not lower.

For now, it may simply be that the modified version of the adage is working: “Don’t fight the Fed chair.”

Calendars

US: Tues: Housing Starts & Building Permits 1.597mu/1.700mu, API Weekly Crude Oil Inventories. **Wed:** MBA Mortgage Applications, Crude Oil Inventories. (Bloomberg estimates)

Global: Tues: Japan Trade Balance ¥460b, BOJ Monetary Policy Meeting Minutes. **Wed:** Australia NAB Quarterly Business Confidence. (Bloomberg estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings ([link](#)): Forward earnings rose for all three of these indexes last week and were at record highs simultaneously for a 19th week and the first time since October 2018. LargeCap's was at a record high for a 20th straight week; MidCap's was at a record for a 23rd week; and SmallCap's posted its 23rd gain in 25 weeks. In what has shaped up to be an extraordinary V-shaped recovery, LargeCap's forward earnings has risen during 60 of the past 61 weeks, with the one down week in late December due to Tesla's addition to the index. MidCap's is up in 57 of the past 59 weeks, and SmallCap's posted 57 gains in the past 60 weeks. LargeCap's forward earnings is now up 44.8% from its lowest level since August 2017; MidCap's has risen 85.4% from its lowest level since May 2015; and SmallCap's is up 132.4% from its lowest point since August 2013. These indexes had been on a forward-earnings uptrend from November 2019 until mid-February, before tumbling due to the Covid-19 economic shutdown. The yearly change in forward earnings soared to cyclical highs during 2018 due to the boost from the Tax Cuts and Jobs Act (TCJA) but began to tumble in October 2018 as y/y comparisons became more difficult. In the latest week, the yearly rate of change in LargeCap's forward earnings was steady at 39.6% y/y and is down from a record high of 40.4% at the end of May. That's up from -19.3% in May 2020, which was the lowest since October 2009. The yearly rate of change in MidCap's forward earnings fell 0.3ppt w/w to 71.7% y/y. That's down from a record high of 78.8% at the end of May and up from record low of -32.7% in May 2020. SmallCap's rate dropped 1.2ppts to 118.4%; it's down from a record high of 124.2% in late June and up from a record low of -41.5% in June 2020. Companies have been easily beating consensus estimates since the Q2-2020 earnings season, causing analysts' y/y earnings growth forecasts for 2021 to improve instead of decline as is typical. Here are the latest consensus earnings growth rates for 2021 and 2022: LargeCap (37.9%, 11.3%), MidCap (62.5, 9.4), and SmallCap (94.0, 16.5).

S&P 500/400/600 Valuation ([link](#)): Valuations moved lower for all three of these indexes last week, and tumbled to 15-month lows for the SMidCaps. LargeCap's forward P/E eased 0.3pt to 21.2 and remains above its eight-month low of 20.7 during mid-June. That compares to a 19-year high of 22.7 in early January and is up from 13.3 in March 2020, which was the lowest since March 2013. MidCap's dropped 0.7pt w/w to a 15-month low of 17.0. That's down from a seven-month high of 20.5 in early March and is 5.9pts below its record high of 22.9 in June 2020. SmallCap's tumbled 0.9pt w/w to a 15-month low of 16.6. It's now down 10.1pts from its record high of 26.7 in early June 2020. During March 2020, MidCap's 10.7 and SmallCap's 11.1 were their lowest readings since March 2009. LargeCap's forward P/E in February 2020—before Covid-19 decimated forward earnings—was 18.9, the highest level since June 2002. Of course, that high was still well below the tech-bubble record high of 25.7 in July 1999. Last week's level compares to the post-Lehman-meltdown P/E of 9.3 in October 2008. MidCap's P/E was below LargeCap's P/E yet again last week, as it has been for most of the time since August 2018. In contrast, it was last solidly above LargeCap's from April 2009 to August 2017. SmallCap's P/E was below LargeCap's for a 42nd week. That's the longest stretch at a discount since last May and during 2002-03. SmallCap's P/E had been mostly below LargeCap's from May 2019 to May 2020 after being solidly above since 2003. SmallCap's P/E was at a discount to MidCap's for a fourth straight week. It had been at an atypical discount to MidCap's around the start of the year for 10 straight weeks.

S&P 500 Sectors Quarterly Earnings Outlook ([link](#)): Since the Q2-2020 earnings season—which came in substantially better than greatly reduced forecasts—analysts as a whole have been raising their consensus forecasts for all future quarters instead of lowering them as is the norm. Those gains have endured even through the earnings warnings season, when forecasts typically decline. In the latest week, the S&P 500's Q2-2021 blended estimate rose \$1.23 to \$46.44 due to positive earnings surprises. That \$46.44 estimate for Q2-2021 represents a gain of 66.0% y/y on a frozen actual basis and a 72.0% y/y gain on a pro forma basis. That would mark the second straight quarter of double-digit percentage growth and compares to a pro forma 52.8% gain in Q1-2021. Ten of the 11 sectors are expected to post positive y/y earnings growth during Q2-2021, the same as during Q1-2021. Here are the S&P 500 sectors' latest expected earnings growth rates for Q2-2021 versus their final Q1-2021 growth rates: Industrials (587.4% in Q2-2021 versus 3.0% in Q1-2021), Consumer Discretionary (280.6, 226.1), Energy (223.5, 28.0), Financials (134.1, 138.0), Materials (118.0, 62.4), S&P 500 (72.0, 52.8), Communication Services (40.2, 53.1), Information Technology (31.8, 44.9), Real Estate (25.5, 5.8), Health Care (12.4, 26.7), Consumer Staples (11.7, 11.1), and Utilities (-0.7, -0.9).

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