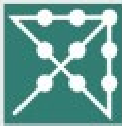
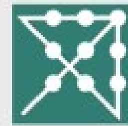
 Yardeni Research 

MORNING BRIEFING
May 4, 2022

Fed Set To Hike by 200 Basis Points

Check out the accompanying chart collection.

Executive Summary: The financial markets have thoroughly discounted the Fed's plan to raise the federal funds rate incrementally by a total of 200bps, so why not dispense with the increments and go for it? That's not in the Fed's data-dependent DNA. … Today, we examine the case for investing in bonds: The Fed is bound to tame inflation one way or another. If inflation drops back to 3.0%-4.0% next year and 2.0% in 2024, as we expect, then a 3.00% 10-year Treasury bond yield is quite interesting. … Also: A look at the ECB's policy playbook, which is much less hawkish than the Fed's.

The Fed: Just Do It! One of our accounts recently asked this good question: If it's widely expected that the Fed is going to raise the federal funds rate to 2.50%—which Fed officials agree is the "neutral" rate—why not just do it in one fell swoop? Why vote for a 50bps hike during today's FOMC meeting only to be followed by three more identical hikes at the next three meetings? Just get it over with!

After all, there are many signs that the financial markets already have fully adjusted to a 2.50% federal funds rate within the next 12 months:

1. The 2-year US Treasury note yield was 2.73%, and the 12-month nearby futures federal funds rate was 3.15% on Monday (*Fig. 1*).
2. The 10-year US Treasury bond yield soared from a record low of 0.52% on August 4, 2020 to 2.99% on Monday (*Fig. 2*).
3. TLT—the iShares 20+ Year Treasury Bond ETF—plunged 31.2% since July 31, 2020 through Tuesday's close and 20.4% ytd!
4. Cathie Wood's ARKK Innovation ETF is down 68.2% from its record high on February 11, 2021 through Tuesday.
5. The 30-year mortgage rate jumped from 3.29% at the start of this year to 5.54% on Monday (*Fig. 3*).
6. The Nasdaq fell 21.9% from its record high on November 19 through Monday (*Fig. 4*).
7. The S&P 500 is down 13.4% from its record high on January 3 through Monday.
8. The forward P/E of the S&P 500 is down from 21.51 to 17.61 over this same period (*Fig. 5*).

9. Bitcoin is down 42.9% from its record high on November 8 through Monday (*Fig. 6*).

Financial conditions have tightened very quickly as Fed officials turned increasingly hawkish in their pronouncements since late last year. So if they've talked the markets into expecting federal funds rate hikes accumulating to 200bps over the next 6-12 months, why not just do it all today?

Because that's not the way the Fed works. Their actions, as they often insist, are data dependent. They've communicated a 50bps hike today and more of the same in coming meetings if the economic data continue to justify such actions. But for all practical purposes, the markets have already adjusted to a 2.50% federal funds rate.

Credit: The Case for Bonds. At 3.00%, the 10-year US Treasury bond yield is 100bps more interesting than it was at 2.00% earlier this year. However, given that the headline CPI and PCED inflation rates were 8.5% and 6.6% during March, might bond yields get even more interesting? After all, why lock in a negative real bond yield?

The obvious answer is that the history of inflation shows that it tends to be spikey, as we discussed in Monday's *Morning Briefing* (*Fig. 7*). It could go higher over the next few months. But 12-24 months from now, it is likely to be lower than it is today. That's because the Fed has pivoted to prioritizing bringing inflation down. In a worst-case scenario, we know that the Fed can bring it down by causing a recession, either by accident or by design.

We continue to project that inflation will fall to 3.0%-4.0% next year. In our Roaring 2020s scenario, it could be back down to 2.0% by 2024 and through the end of the decade. So 3.00% on the bond yield is looking very interesting. Here are a few related considerations:

(1) *Trend change.* The 40-year secular bull market in bonds probably ended when the 10-year yield fell to 0.52% on August 4, 2020. However, that doesn't necessarily mean that we are now in a secular bear market. We wouldn't be surprised to see a range-bound market between 2.50% and 3.50% for the rest of the decade (*Fig. 8*).

(2) *Copper/gold ratio.* The 10-year bond yield has tended to trade closely to the copper/gold price ratio (*Fig. 9*). It was mostly below this ratio during 2020 and 2021. It finally converged with the ratio a few weeks ago when the yield was around 2.50% on its way to 3.00%. Now it exceeds the ratio, which is more consistent with 2.50%. The current yield is actually more in line with the ratio of the nearby crude oil futures price to the nearby gold futures price (*Fig. 10*).

(3) *Surprise index.* Keep an eye on the Citibank Economic Surprise Index (ESI), which tends to be highly correlated with the 13-week change in the 10-year bond yield (*Fig. 11*). The ESI may be peaking, reflecting weaker-than-expected economic indicators. That also would signal that 3.00% might be an attractive yield.

(4) *Purchasing managers.* Finally, the M-PMI tends to be a coincident and sometimes leading indicator of the 10-year bond yield (*Fig. 12*). The M-PMI has dropped from 60.8 during October to 55.4 during April.

Global Central Banks: The ECB's Playbook. The world is experiencing multiple crises, European Central Bank (ECB) President Christine Lagarde emphasized in an April 22 *interview* with CNN. The ECB recently lowered its forecast for the Eurozone's real GDP growth this year to 3.7% from 4.2%. And that's the optimistic scenario. If further supply-chain disruptions and weakened consumer confidence resulting from Russia's war on Ukraine turn out not to be temporary, then the outlook for growth could further weaken.

Rising costs from the war have been pressuring Eurozone businesses. S&P Global's composite Purchasing Managers Index for the Eurozone climbed to a seven-month high of 55.8 in April, according to flash estimates (final data haven't yet been released as we write this on May 3), though it continues to fluctuate in a volatile flat trend below its recent high of 60.2 last July (*Fig. 13*). Energy prices already were elevated when the war began on February 24, causing input prices to accelerate at a near-record pace. Eurozone consumer sentiment has been markedly weak, sinking from 117.4 in September to a 13-month low of 105.0 in April (*Fig. 14*).

Despite the weakening outlook, the ECB has *committed* to reducing its government bond purchases through Q2 to combat rising inflation. In contrast to the hawkish interest-rate path expected by the Fed, the ECB's governing council said it may raise interest rates "some time" after its bond buying ends. Here's more on the ECB's playbook:

(1) *Data dependent.* In its March 10 *monetary policy decisions*, the ECB revised its schedule for the asset purchase program to €40 billion in April, €30 billion in May, and €20 billion in June. Net purchases for Q3 would be data dependent, the bank stated. In its latest April 14 *monetary policy decisions*, the ECB firmly reiterated that its asset purchases should end in Q3, as inflation pressures had intensified across many sectors.

Assets on the ECB's balance sheet rose by €4.1 trillion to €8.8 trillion from the start of 2020 to now (*Fig. 15*). Emergency pandemic-related net asset purchases, which largely account

for the assets the ECB holds, stopped at the end of March (with reinvestments of principal payments expected through 2024) but could be "resumed, if necessary, to counter negative shocks related to the pandemic."

(2) *'Some time' is flexible.* Adjustments to key interest rates "will take place some time after the end of the Governing Council's net purchases under the APP and will be gradual," the ECB's March statement said. The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility stand at 0.00%, 0.25%, and -0.50%, respectively.

ECB Vice-President Luis de Guindos said in a May 1 *interview* that a rate increase is possible in July, but the timing will be clearer after the bank updates its macroeconomic projections in June. A rate increase certainly wouldn't come later than September, sources recently *told* Reuters.

Nevertheless, the ECB remains data dependent and flexible. Politico *quipped* that "flexibility" for the next few months is "ECB code for having a plan B in case the European Union abandons its current restraint and imposes a full embargo on Russian energy imports."

(3) *Normalizing isn't tightening.* Guindos' interviewers noted that the market already is pricing in two rate hikes from the ECB this year. In her interview with CNN, Lagarde tried to tamp down that notion. She stressed that the semantics of any increase were important, characterizing a future increase as "normalizing" rather than "tightening" because of the bank's continued accommodative stance. Anyone looking to borrow in future months will continue to find lending rates quite low, she said.

That was Lagarde's likely attempt to quell concerns from the most recent Eurozone bank lending survey, which reported that credit standards for loans to firms and for housing loans tightened during Q1 as lenders became more concerned about the risks facing their customers in an uncertain environment.

In the bond market, investors expect to be compensated for the uncertainty as well. Long-term Eurozone bond yields have increased substantially since the March Governing Council meeting. German 10-year sovereign bond yields increased by 94bps during March and April and reached the 1.00% level yesterday for the first time in nearly seven years (*Fig. 16*).

(4) *Slowed growth isn't recession.* In 2022, growth will be positive, Guindos said, adding: "if

we stick to the technical definition of a recession—two consecutive quarters of negative growth—we currently don't see it." While the invasion of Ukraine is expected to increase inflationary pressures and reduce economic growth, he said, the ECB wouldn't expect a recession even in the adverse scenario that Germany *cut off* its Russian gas supplies.

(5) *High inflation isn't durable.* "Inflation has increased significantly and will remain high over the coming months, mainly because of the sharp rise in energy costs," the ECB stated in its April monetary policy decision. Sure, current headline inflation in the Eurozone—which rose to 7.5% during April, according to its flash estimate—is dwarfing the ECB's 2.0% target for inflation (*Fig. 17*).

But as of now, inflation is expected to stabilize in the medium term. The bank's Q2 *Survey of Professional Forecasters* revised up inflation expectations for 2022 and 2023 but left them unchanged for 2024 at 1.9%. In March and again in April, the Governing Council said in its decision statements that it needs to see inflation "durably" rise for the rest of the projection horizon toward its 2.0% target for the bank to raise rates. Measures of underlying inflation watched by the ECB are not quite as stark as the headline rate. (For more indicators of underlying inflation, see the bank's chart 8 in the March *Economic Bulletin*.)

(6) *Wage inflation distorted.* Wage inflation hasn't yet jeopardized the ECB's long-term target, but it is a delayed indicator, Guindos said. The ECB's March *Economic Bulletin* noted that Q4-2021 data continued to point to "relatively moderate annual growth in both negotiated wages (1.6%) and actual wages, where growth in compensation per hour and growth in compensation per employee stood at 1.1% and 3.5% respectively, although the latter was considerably distorted upwards owing to the impact of job retention schemes."

(7) *Policies going green*. Entangling fiscal and monetary policy in its March *Economic Bulletin*, the ECB suggested that the successful implementation of the investment and reform plans under the Next Generation EU program will accelerate the energy and green transitions. The bulletin did not mention that the stimulatory nature of the fiscal funds could run counter to the ECB's attempt to "normalize" monetary policy. In fairness, the efforts could support reduced dependence on Russian energy.

Calendars

US: Wed: ADP Employment 395k; Motor Vehicle Sales; Trade Balance -$107.0b; ISM N-

PMI 58.5; MBA Mortgage Applications; Crude Oil Inventories & Gasoline Production; Fed Interest Rate Decision 1.00%. **Thurs:** Productivity & Unit Labor Costs -5.4%/9.9%; Initial & Continuous Jobless Claims 182k/1.4m; Natural Gas Storage; OPEC Meeting. (Bloomberg estimates)

Global: Wed: Eurozone, Germany, and France C-PMIs 55.8/54.5/57.5/; Eurozone, Germany, and France NM-PMIs 57.7/57.9/58.8; Eurozone Retail Sales -0.1%m/m/1.4%y/y; Germany Trade Balance, Exports & Imports €9.5b/-1.8%/1.5%; Canada Trade Balance $3.8b; ECB Non-Monetary Policy Meeting; Wuermeling; Balz; Woods. **Thurs:** Germany Factory Orders -1.1%; France Industrial Production 0.2%; UK C-PMI & NM-PMI 57.6/58.3; BOE Interest Rate Decision & BOE QE Total 1.00%/842b; BOE Inflation Report; RBA Monetary Policy Statement; Lane; Beerman; Bailey. (Bloomberg estimates)

US Economic Indicators

JOLTS (*link*): Job openings in March climbed to a new record high, as did the number of quits. Job openings advanced for the third time in four months, by 205,000 m/m and 627,000 over the period to 11.549 million. There were 5.95 million unemployed in March, so there were 1.9 million available jobs for each unemployed person that month. By industry, retail trade (+155,000), professional & business services (+103,000), finance & insurance (+51,000), and durable goods manufacturing (+50,000) posted the largest gains, while the biggest losses were recorded by transportation & warehousing (-69,000), accommodations & food services (-59,000), state & local government education (-43,000), wholesale trade (-41,000), and the federal government (-20,000). The number of quits remains on a sharp accelerating trend, climbing 152,000 in March and 278,000 during the two months through March to a record-high 4.536 million. Before the pandemic, quits hovered around 3.5 million. Many employers are raising wages and incentives amid a severe labor shortage, which gives workers confidence that they can get better pay elsewhere. Hirings remain on a volatile uptrend, though slipped 95,000 in March to 6.737 million. Still, they are up 1.1 million since the recent bottom during December 2020.

Manufacturing Orders & Shipments (*link*): Factory orders were stronger than expected in March, and shipments were also strong. Core capital goods orders and shipments both reached new record highs again in March. Nondefense capital goods shipments excluding aircraft (used in calculating GDP) has climbed every month but one since its April 2020 bottom, rising an upwardly revised 0.4% (from 0.2%) in March and 34.5% over the period.

Meanwhile, core capital goods orders (a proxy for future business investment) rebounded an upwardly revised 1.3% (from 1.0%) in March, more than reversing February's 0.2% loss—which was only the second decline since its April 2020 bottom; it has climbed 35.5% since that bottom. Total factory orders climbed 2.2% in March and 14.2% y/y to within 1.2% of a new record high. The increase in factory orders was fairly widespread, led by metalworking machinery (13.4%), material handling equipment (5.9), construction machinery (5.5), electrical equipment, appliances & components (4.4), motor vehicle & parts (3.1), mining, oil & gas field (3.0), primary metals (2.2), and electronic components (2.0). Overall factory shipments continued to reach new record highs in March, jumping 2.3% m/m and 14.5% y/y.

Global Economic Indicators

Eurozone Economic Sentiment Indicators (*link*): The Economic Sentiment Index (ESI) took another hit in April, with ESIs in both the EU (to 104.9 from 116.0 during October) and the Eurozone (105.0 from 117.4) falling in April for the fifth time in six months. Among the largest EU countries, April's performance was a mixed bag, with ESIs in Spain (-4.5 points to 100.2) and France (-1.4 to 102.8) falling, while ESIs in Germany (-0.1 to 107.1) and Poland (+0.3 to 98.6) were broadly stable and Italy's (+1.3 to 105.4) rose. All are down sharply from recent highs. For the overall Eurozone at the sector level, consumer confidence continues to plunge, collapsing from -1.8 in mid-2021 to -22.0 this April—reflecting marked declines in households' assessments of their own past financial situation and their intentions to make major purchases. Retail trade confidence is also in negative territory, falling further below zero in April to -4.3, deteriorating from its recent peak of 6.0 last August, while industrial confidence has dropped the past two months, to 7.9 in April, after hovering around 13.5 for eight months. Meanwhile, services confidence slipped to 13.5 in April but that's a level not far from its recent high of 17.9 in October, while confidence within the construction sector followed a similar pattern, declining to 7.1 but remaining near its recent high of 10.5 in December.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306
Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432

Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102

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