Richard Bernstein Advisors

RBA Fixed Income Insights

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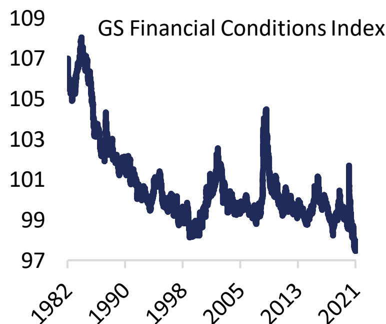
Painting the Fence

With the yield curve the steepest since 2016 and speculative technology shares starting to feel the weight of higher discount rates, the Fed had several opportunities last week to put an end to rising Treasury yields. Yet, Chair Powell indicated not only is he not concerned about higher rates, but he welcomes them as a vote of confidence for the economy.

At first blush, Powell's rhetoric could be interpreted many ways: optimistic at best, negligent to the perils of higher rates at worst. But a deeper dive shows the Fed has a larger plan at hand. One that is playing out exactly as they would want and precisely with the consequences they desire.

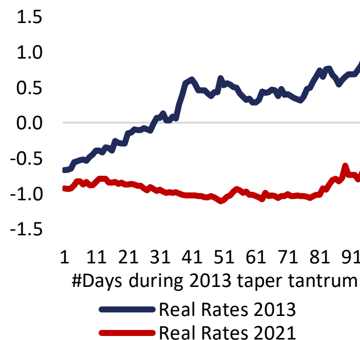
1) Real, not nominal, rates matter to economic growth, and the Fed has been able to raise inflation expectations with only modest moves in real rates and still maintaining historically loose financial conditions (Chart 1).
2) The Fed has let the market push forward rate hike expectations, enabling the committee to avoid a communication misstep like the one that caused 2013's so-called "Taper Tantrum" (Chart 2).
3) The Fed has let the market reduce the froth in speculative tech and begin the rotation towards cyclicality.
4) The Fed has likely sparked what could be the greatest corporate balance sheet repair in history.
5) The Fed knows that without increasing their long run "neutral policy rate"- the rate at which the economy can maintain full employment and inflation at 2% - there should be a natural "ceiling" to long-end rates (Chart 3).

Chart 1: Financial Conditions are the loosest in history



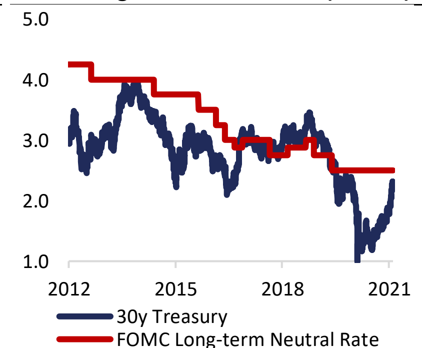
Source: Richard Bernstein Advisors LLC, Bloomberg, Goldman Sachs

Chart 2: Real rates haven't moved nearly as much as during the taper tantrum



Source: Richard Bernstein Advisors LLC, Bloomberg

Chart 3: Fed steps in once 30y yields goes above Long-Term Neutral Rate ('13/'18):



Source: Richard Bernstein Advisors LLC, Bloomberg, Federal Reserve

By letting the market do its dirty work, the committee can sit back and let growth run hot while retaining their limited tools for periods of real stress. If real rates spike like in 2013, causing the 30-year bond yield to gap above the neutral rate and equities to fall, they retain the power to change their asset purchases to

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reset expectations. As a result, any tightening of financial conditions will be a temporary phenomenon and the medium-to-long-term trajectory is likely to follow the Fed's explicit and implicit goals: loose financial conditions and less froth in financial markets.

With this accommodative backdrop, we expect tighter corporate bond spreads, an environment positive for small caps, and a further rotation out of long duration proxies and into value assets. Like Tom Sawyer tricking the boy to paint the fence for him, Chair Powell has convinced the market to do his job.

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