Stargazer
Asset Management

What to focus on in Global Macro for the week of January 10th, 2022

Macro Themes on the Radar:

There is little doubt that last week's release of the December FOMC meeting minutes read more hawkish than the actual statement or press conference after the meeting did.

The minutes had an extra dose of urgency regarding the need to get started with hikes (the market is now pricing an 80+% chance of a March hike) and, maybe, more importantly, a focus on not just ending QE but getting going on reducing the size of the balance sheet. This is particularly interesting since they seem to see it as an alternate policy (tightening) tool that could replace some of the future rate hikes.

*"**Some participants commented that removing policy accommodation by relying more on balance sheet reduction and less on increases in the policy rate could help limit yield curve flattening during policy normalization**.*

Participants generally noted that, given their individual outlooks for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated.

Participants had an initial discussion about the appropriate conditions and timing for starting balance sheet runoff relative to raising the federal funds rate from the ELB. They also discussed how this relative timing might differ from the previous experience, in which balance sheet runoff commenced almost two years after policy rate liftoff when the normalization of the federal funds rate was judged to be well under way. Almost all participants agreed that it would likely be appropriate to initiate balance sheet runoff at some point after the first increase in the target range for the federal funds rate.

*Some participants also noted that it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively **soon** after beginning to raise the federal funds rate.*

*Many participants judged that the appropriate pace of balance sheet runoff would likely be **faster** than it was during the previous normalization episode. "*

Two FOMC members spoke subsequent to the release of the minutes. St. Louis Fed Bullard noted reduction in the balance sheet will mean less need for aggressive rate hikes, but urged a March hike, while San Francisco Fed Daly noted balance sheet moves should happen after the first hike. Timing and speed of moves remain the focus for January 11th and Powell's testimony in front of the Senate Banking Committee. If they hike in March, expect QT to be announced as soon as the May or June meeting, precluding downside economic surprises.

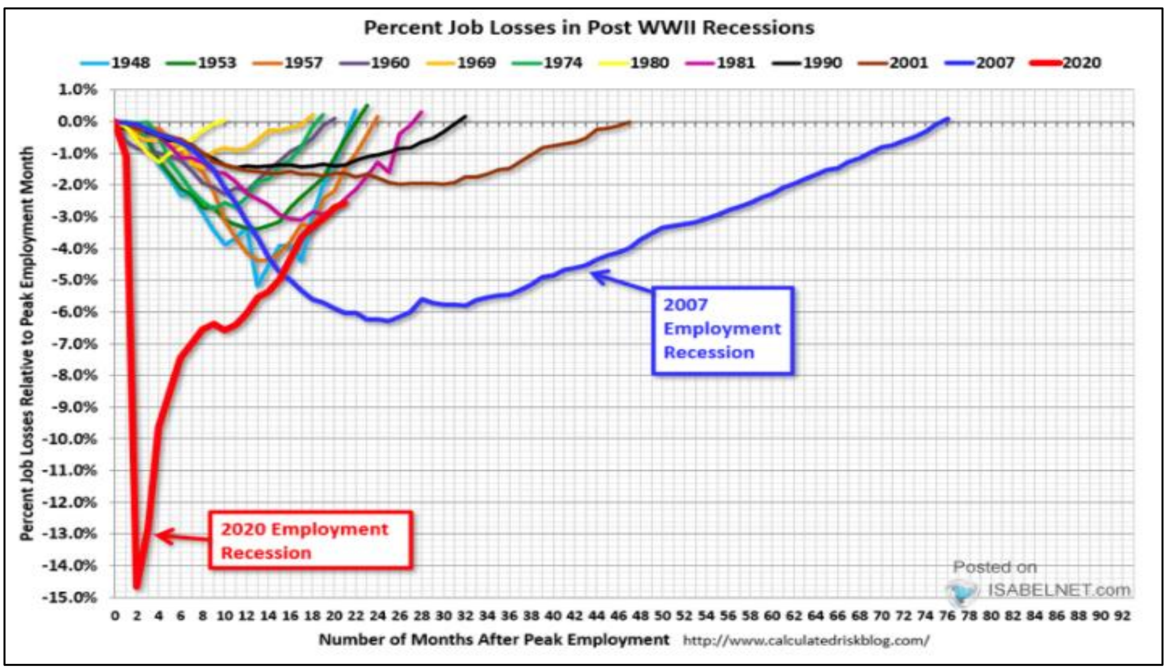
Don't expect Friday's weak headline payrolls data to hold them back given that the wage growth and unemployment rate strengthened further. At current participation rates, the labor market is tight.

With Powell's testimony on Tuesday and CPI on Wednesday, mid-week could see the bulk of the price action. This is still expected to be another strong CPI print, with headline expected around 7-7.1% and core closing in one 5.5%.

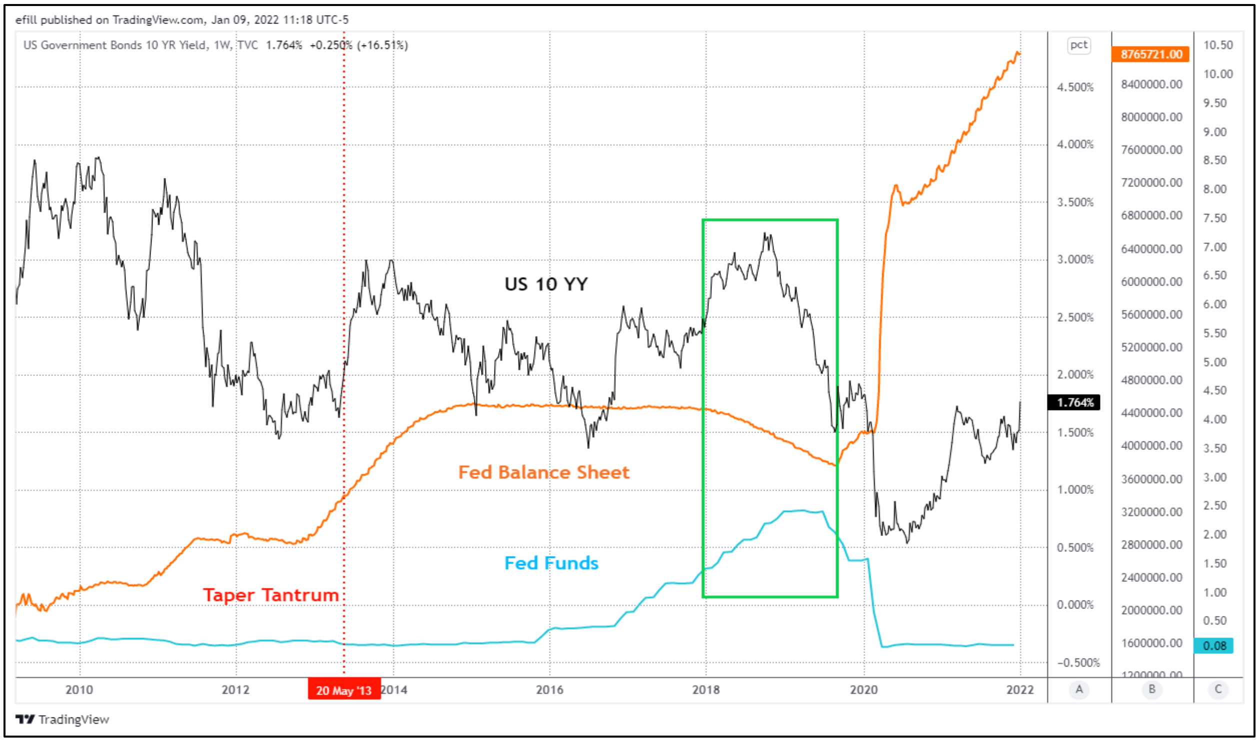
Now what?

It is very hard to look at past periods for guidance here. As you know, COVID and the governments' reaction to it, has broken nearly all precedents.

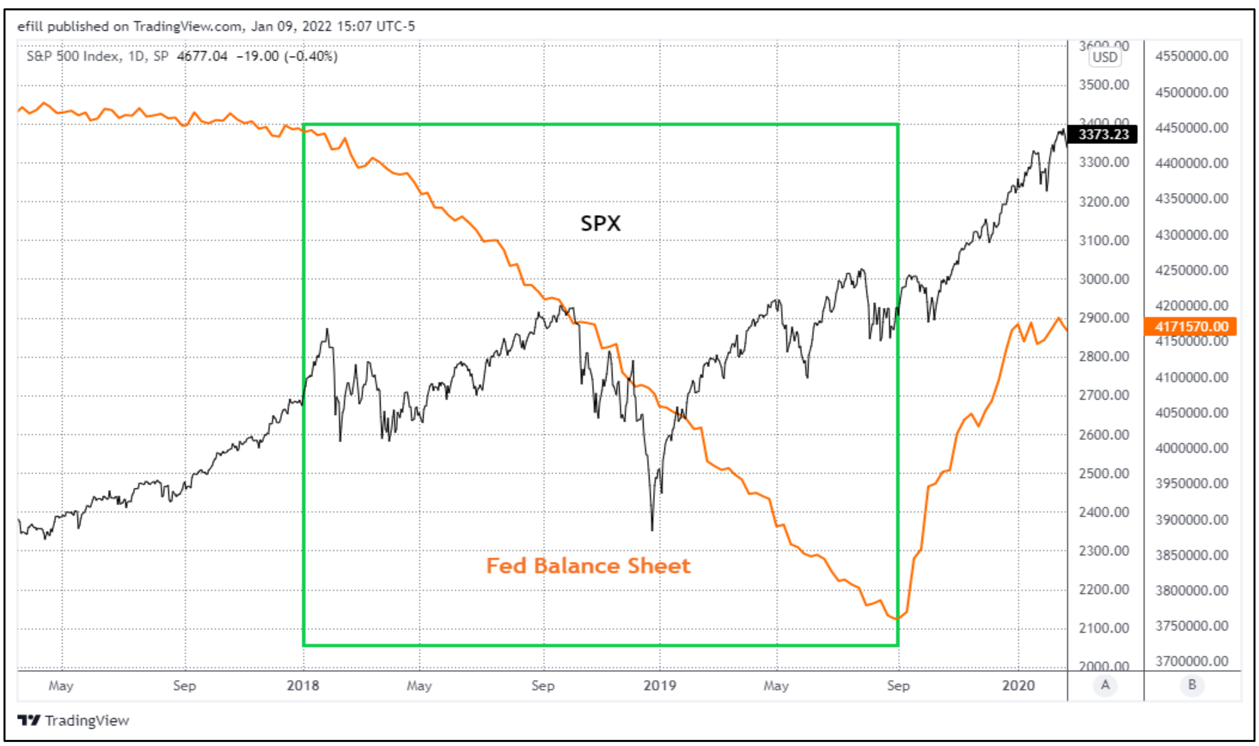
This chart of employment losses and recoveries in post-WWII recessions illustrates just how different the current environment is.



QT, Inflation, and Yields - Since the Fed started to utilize QE during the GFC, yields have fallen when the Fed tapered and then ended QE. Will we get that again? So far, long end yields look more like they are breaking out to the upside. The idea of using QT as a policy tool may well have something to do with that as (like the minutes suggest) it would allow them to go more slowly with rate hikes, than if that was their only tool for reducing accommodation. In some ways, it would also allow them to more slowly tighten the screws on the real economy (Main Street) while taking some of the wind out of the highly valued financial markets (Wall Street). Turning to QT as a policy tool looks like another experiment in monetary policy. Now, to be fair, we have done QT during a tightening cycle in 2018-2019. However, at the time it was not billed as an alternative to hikes, but as an opportunity to reduce the balance sheet.

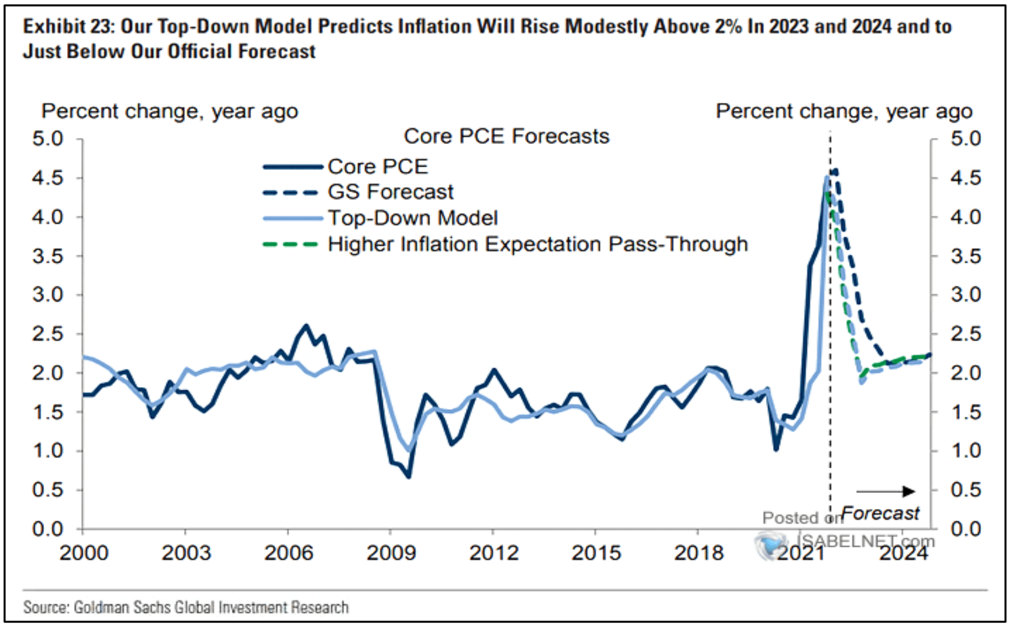


Yields initially rose as QT started on top of ongoing hikes, then fell (above). Equities experienced a very volatile period that included large oscillations (below).



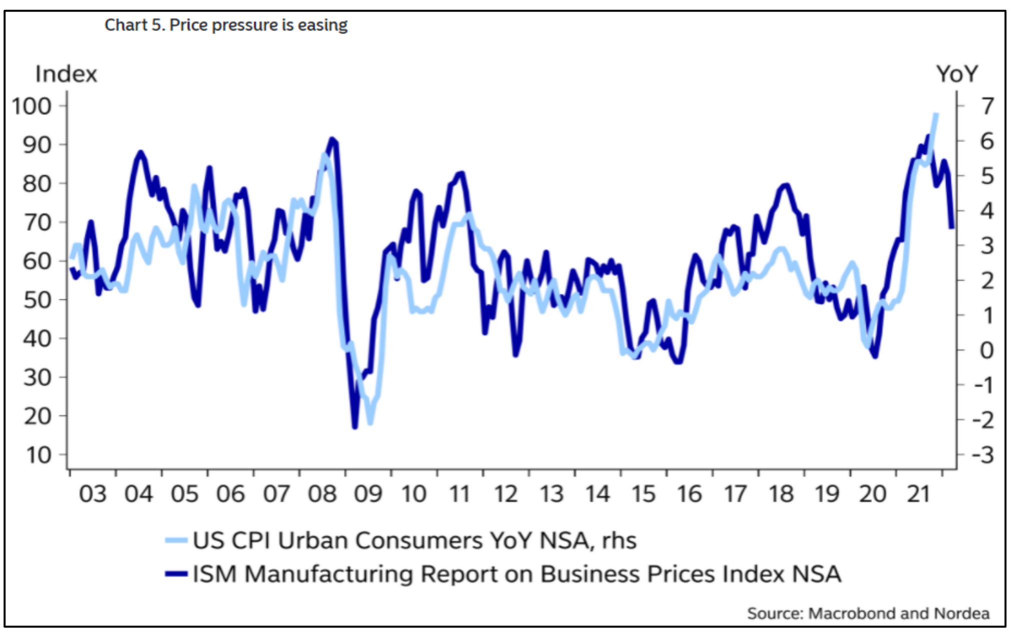
Of course, no two periods are the same, and the differences now are numerous and important. For many months, the Fed was buying more than all the new issuance of Treasuries, as the government ran down its account with the Fed (the TGA). That is now essentially exhausted. There will be meaningful new issuance going forward, while at the same time the Fed goes from buying $120bln in Treasuries and MBS to allowing them to start running off its books. One big difference this time is that the average duration of the balance sheet is now much shorter than it had been previously.

Making things more complicated this time, is the surge in inflation, and the discussion around how persistent it will be.

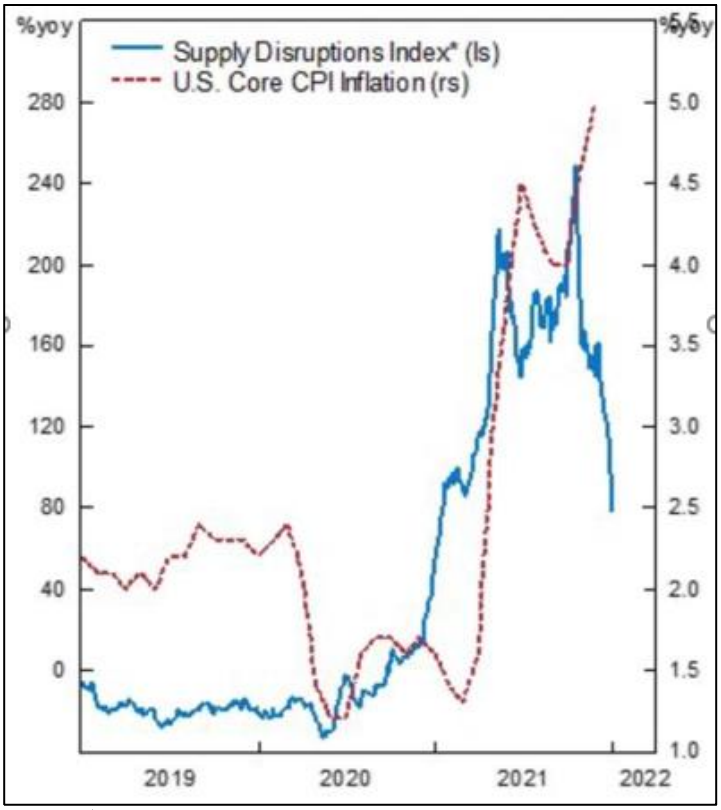


While the numbers are likely to get a bit worse before they get better, we should be nearing the peak of this run higher.

The big question is to what degree do housing and wage pressure limit the pullback?



There are also signs that some of the supply constraints and bottlenecks are starting to improve.



Source: Alpine Macro

Alpine Macro put out this dramatic chart, pointing out how their Supply Disruptions Index continues to fall away, suggesting that a faster than expected fall in core PCE may follow.

We will see, but these markets should stay volatile as the Fed pulls levers in a very uncertain environment with an unusual mix of inputs.

What to Focus on Now:

Last week's move higher in both the front-end and long-end yields was dramatic.

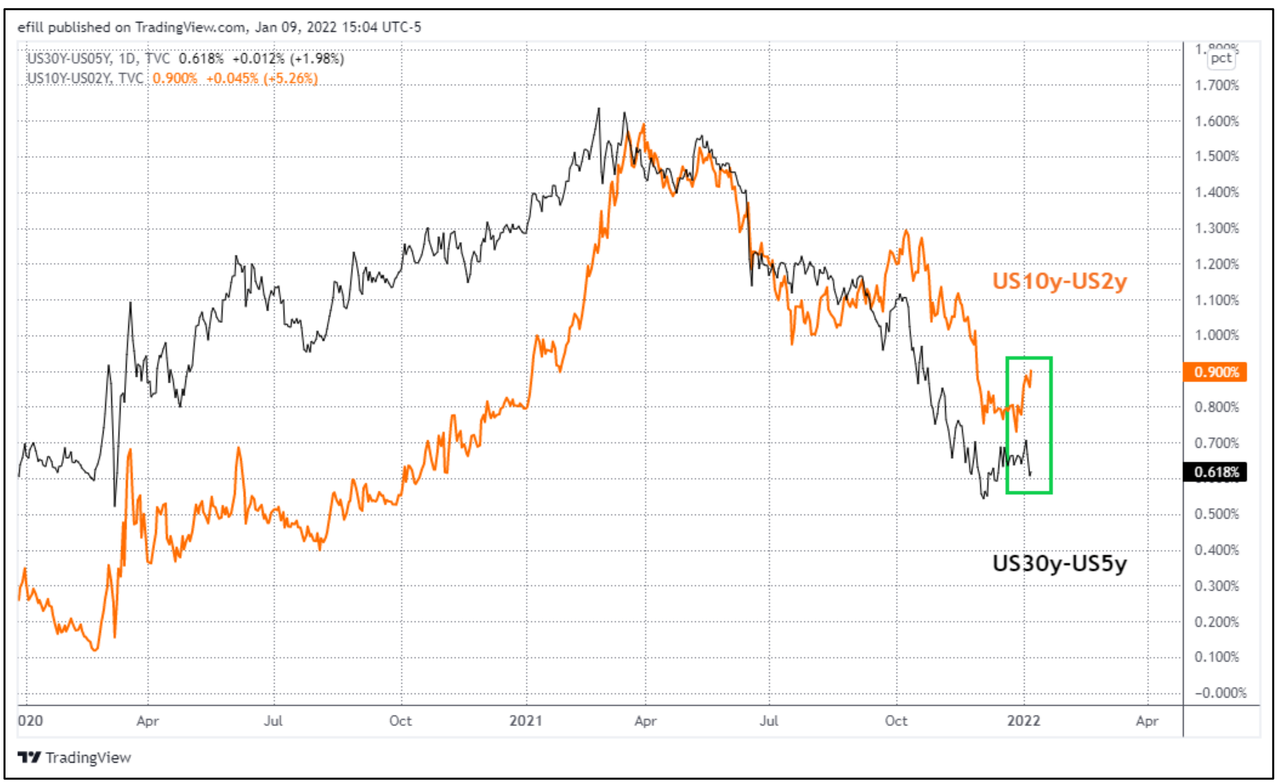
We largely priced the first hike in March and three and a half hikes by the end of the year. At this point, you have to wonder if that is too much, or at least whether the risk/reward is now starting to tilt the other way.

By their own admission, the implementation of QT and an earlier initial hike could take the pressure off of them in the second half of the year. There are so many variables, but we have now priced a lot.

The long end is certainly more interesting on the charts at this point. 10-year yields have cracked last year's highs and 30-year yields are threatening a breakout of their own.

Largely, the whole curve moved higher last week, leaving only the long end a little flatter.


efill published on TradingView.com, Jan 09, 2022 13:25 UTC-5
US Government Bonds 10 YR Yield, 1D, TVC 1.764% +0.039% (+2.26%)
US 10 year yield
United States 30 Year Government Bonds Yield, 1D, TVC 2.118% +0.040% (+1.92%)
US 30 year yield
TradingView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US30Y-US05Y, 1D, TVC 0.618% +0.012% (+1.98%)
US10Y-US02Y, TVC 0.900% +0.045% (+5.26%)
US10y-US2y
US30y-US5y
TradingView

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It was a wild week in terms of market rotation as investors dumped long duration stocks in favor of value. For once it had some follow-through.

In the big picture, people have maintained a high level of allocation in an expensive and narrow market. Can we successfully transition to a broader value market despite the size and importance of the FAAMG in the indices?

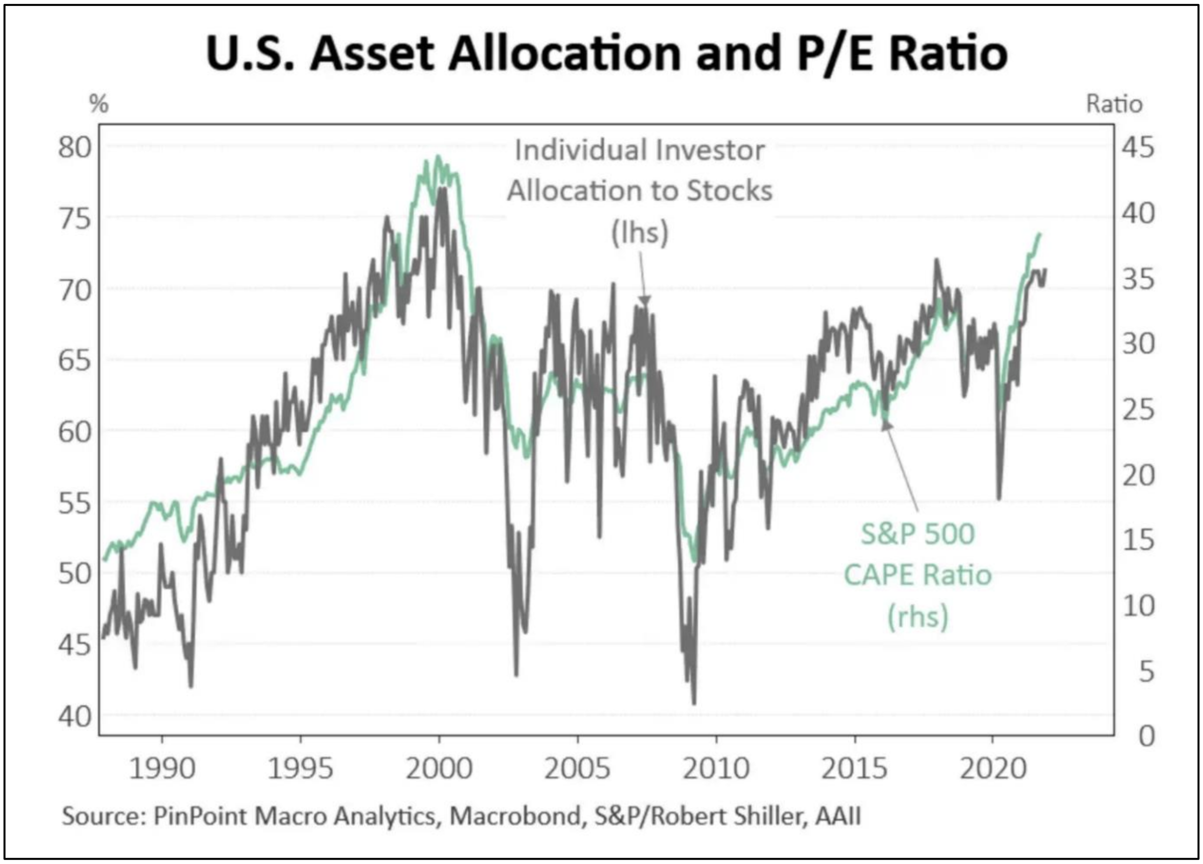


Table 1: Market cap of FAAMG the 3rd largest "country"

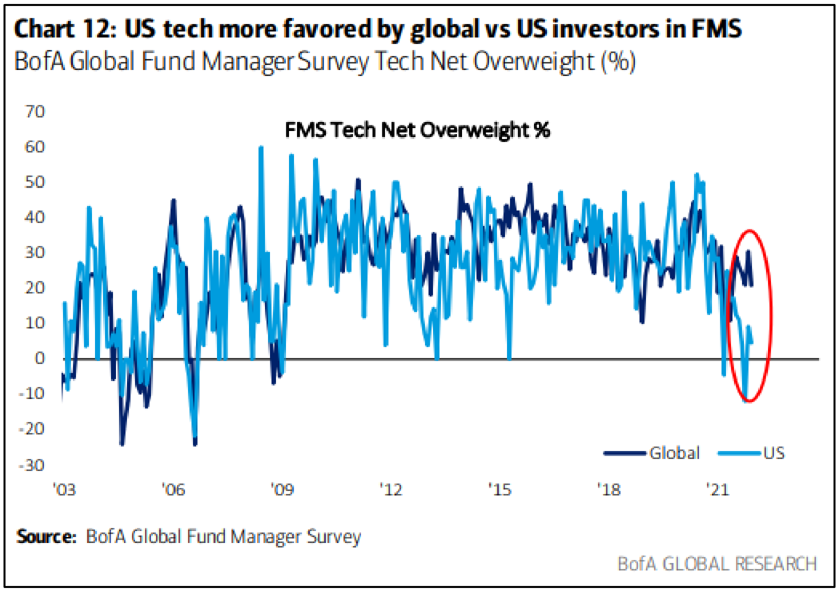
FAAMG Market cap vs world GDP

Country	$ trillion
United States	22.9
China	16.9
FAAMG	10.1
Japan	5.1
Germany	3.2
United Kingdom	3.1

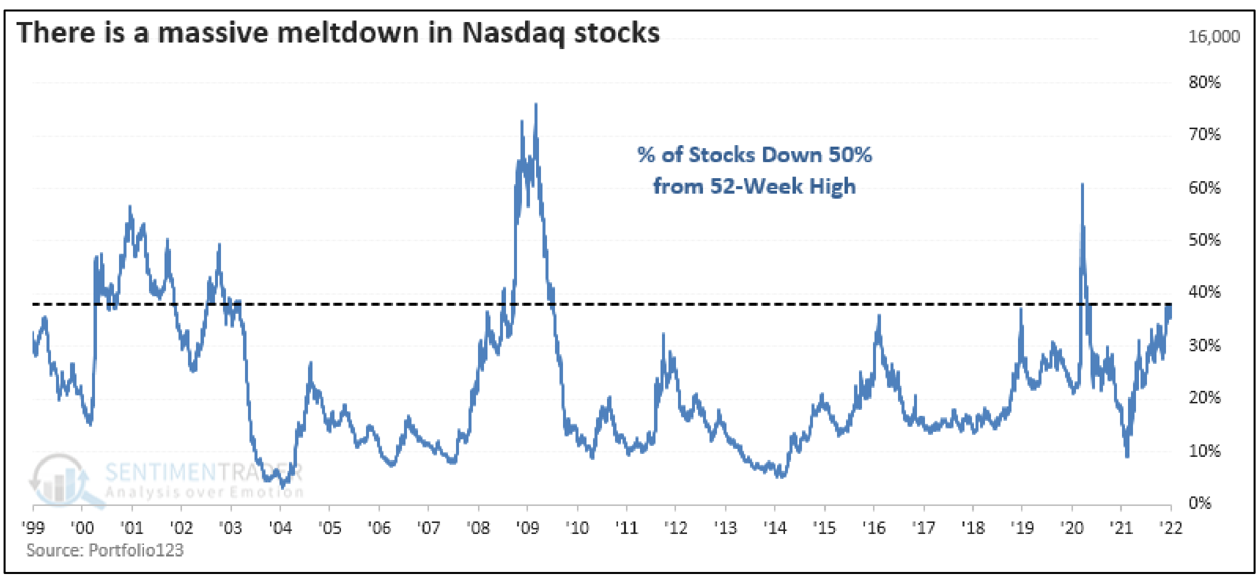
Source: BofA Global Investment Strategy, Bloomberg

BofA GLOBAL RESEARCH

Foreign investors like them even more than US investors.



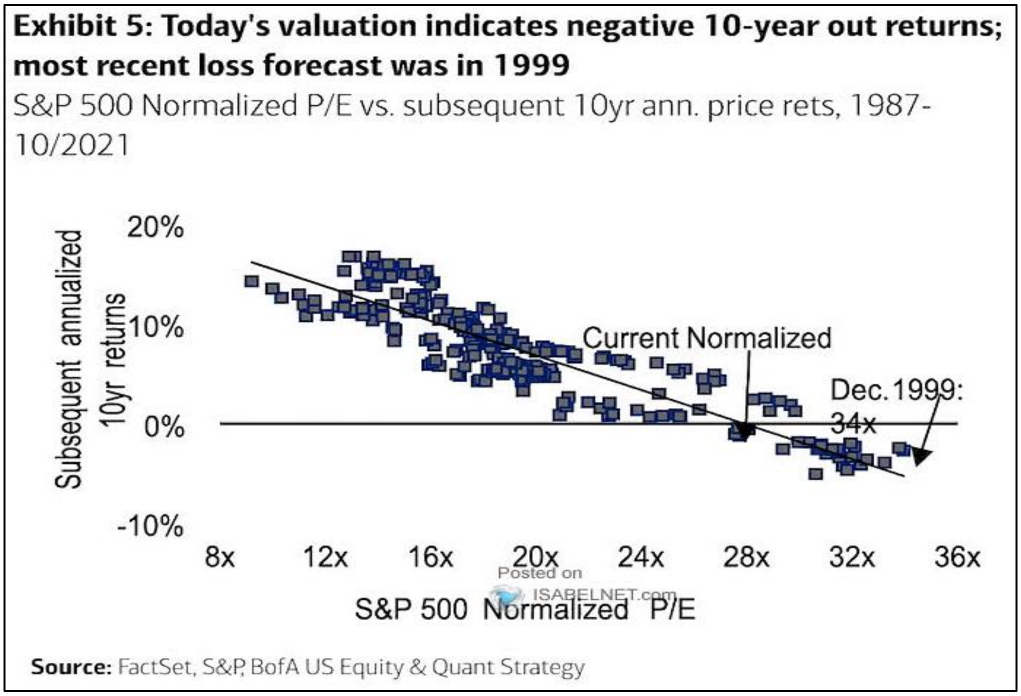
At the same time, the aspirational YOLO and meme stocks have been crushed already. This chart from Sentiment Trader has been making the rounds in recent days, but I thought I would include it in case you missed it.



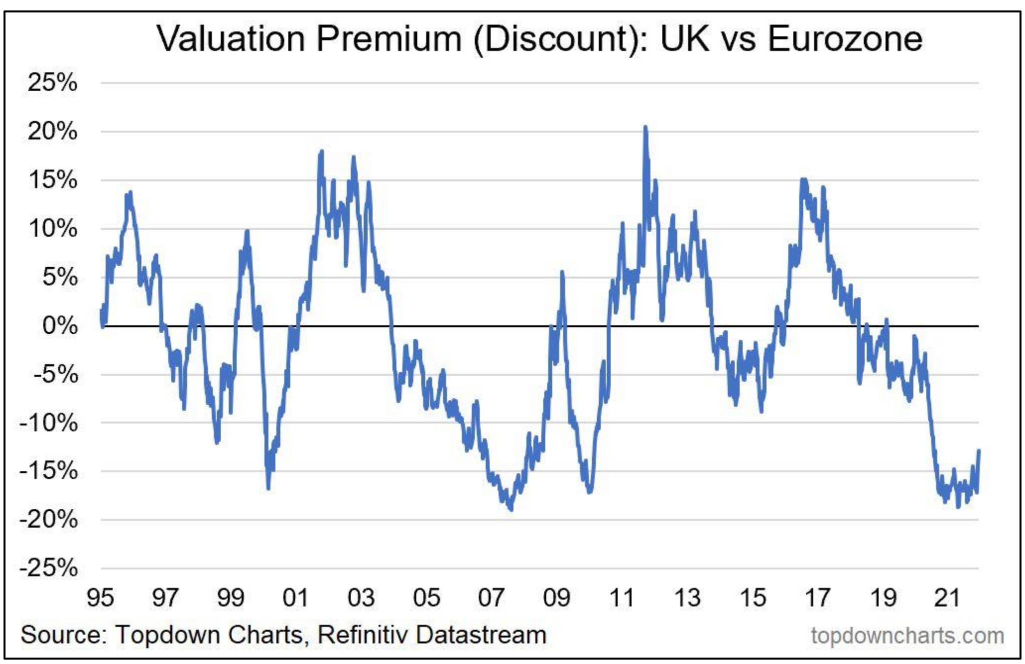
They point out: *"At no other point since at least 1999 have so many stocks been cut in half while the Nasdaq Composite index was so close to its peak. When at least 35% of stocks are down by half, the Composite has been down by an average of 47% (!) from its 3-year high.*

Bulls will suggest that most of the damage has been done, and the indexes should be able to soar from here. Bears will say this is just like the internet bubble, and the index is about to "catch down" to the average stock."

For US stocks, and by extension the large cap tech drivers, forward returns look challenging.



So, with global CB accommodation receding, what is value? Globally, the UK is worth a look. It is cheaper than Europe.



And the long-suffering GBP could be primed for better days, both against the USD and more broadly.

The combination of a rising Pound and better equity performance could make EWU attractive. Either outright or vs. big cap US.

Energy had a big week last week in absolute terms. In relative terms, it is now at a very interesting level vs. the S&P.

For all the value trades, the USD and how it interacts with higher long end yields will be important.

Higher yields AND a higher USD will quickly tighten financial conditions, as it did in 2018, making for volatile markets. However, a falling USD while yields rise would goose the value trades both within the US and globally. It sounds counter-intuitive but it can certainly happen... we will see.

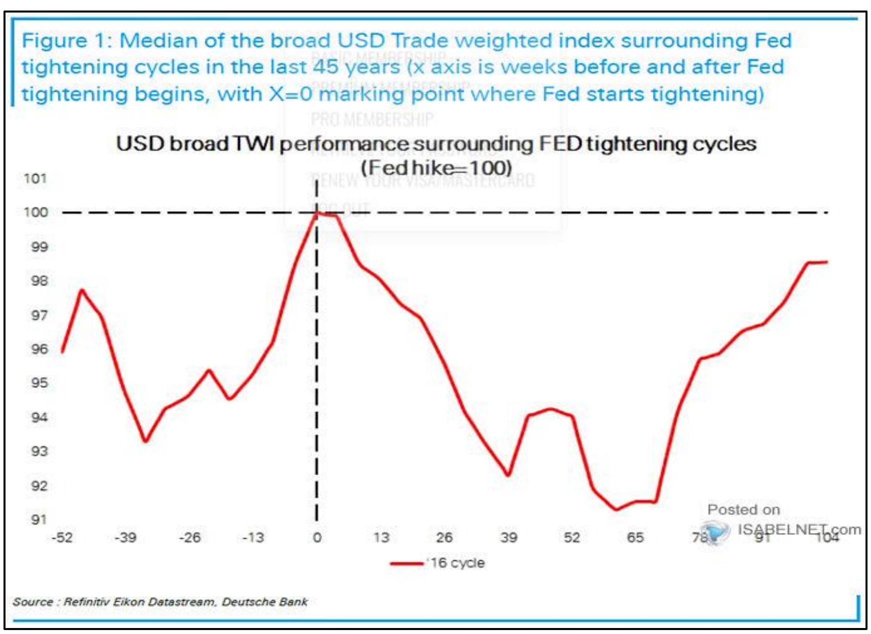
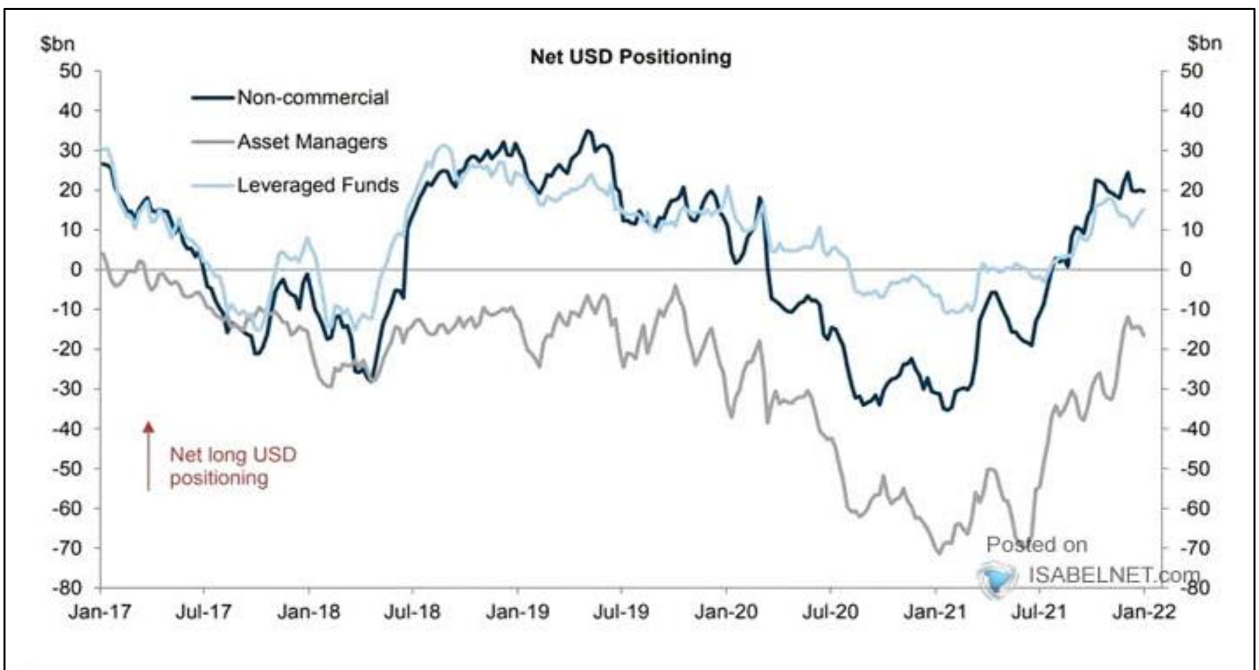


Figure 1: Median of the broad USD Trade weighted index surrounding Fed tightening cycles in the last 45 years (x axis is weeks before and after Fed tightening begins, with X=0 marking point where Fed starts tightening)

A break higher through 97 in the DXY will create a headwind, while a break below 95.50 will deliver a tailwind for global growth. While there has been quite a lot of dispersion in FX recently, the EUR heavy DXY has been stuck for two months.

There has been a lot of talk about how everyone is long USD, but it's not a great contrary indicator.



Source: Haver Analytics, Goldman Sachs Global Investment Research

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If we were to get higher yields and continued global growth WITH a weaker USD more generally, this could be a very interesting trade.

Also, in the keep it on your radar category, these are big levels for risk parity strategies.

Important Macro Data Releases and Events for the Week

Monday 1/10/2022	Retail Sales and Trade Balance (Nov)
Tuesday 1/11/2022	Outgoing German Buba President Weidmann speech
	Fed's Chair Powell Testifies before Congress
	CPI (Dec)
Wednesday 1/12/2022	**CPI Headline and Core (Dec)**
Thursday 1/13/2022	Initial Jobless Claims
	Initial Jobless Claims 4-week average
	Continuing Jobless Claims
	PPI Headline and Core (Dec)
	Trade Date (Dec)
Friday 1/14/2022	Retail Sales (Dec)
	Michigan Consumer Sentiment (Jan)

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