The charge of bond vigilantes

They are back. It has been a long time since they dared to show their strength. They seemed to be out of history, shredded by a new world advancing with different rules. But no. They are still there. They had simply put themselves on hold as they assessed the right time to reappear. They are known to be the most powerful force in the marketplace. Its adherents are asked for a vision beyond the short term. Because they master the tool to mathematically discount the future. When they move they are able to disrupt all markets, from the stock market to the currency one. They are the bond vigilantes, as economist Edward Yardeni called them in the 1980s. If they are convinced that monetary or fiscal policies are inflationary, they use a very simple lever: they sell bonds. By doing so, they increase yields, hence interest rates. But they have to be very careful. They have to assess the consequences of their actions, because they can be severely punished. The task of managing interest rates falls to the central banks. In the past they concentrated on short-term interest rates, while the market could work on long-term ones. This was the boundless territory of bond vigilantes. Their main concern is that the investor be fairly compensated for the risk he or she takes. So if they perceive that inflation is rising or that the risk (for bond holders) of not being repaid at maturity is increasing, they immediately demand higher yields: they devalue the bond market causing rates to rise. Bonds, once considered a safe haven for the investor, are the central hub of the markets precisely because they determine the cost of capital that serves as a benchmark for all financial assets.

Apparently the Federal Reserve has been keeping a watchful eye on bond vigilantes for a long time: central banks have unlimited power to buy what they might be tempted to sell. Especially in an environment where growth is languishing and inflation is struggling. An aging population, digitization and globalization are structural phenomena that block price increases. The coronavirus then infected global growth by driving up bond prices and thus compressing yields. Negative rates (real or nominal), which central banks have exacerbated over the past year, could not be discussed by bond vigilantes, as there were no inflation expectations. Especially since the velocity of money also remained confined to savings, given the difficulty of spending.

But the bond vigilantes, in recent weeks, seem to be convinced that the central banks are getting it wrong: the rate of the ten-year US Treasury rose in a short time from 1 to 1.6 percent. The stock exchanges immediately reacted by realizing the gains of the year, especially in the digital sector, where the parameters of the models that discount future cash flows were revised. This brought bond yields closer to dividend yields. As a result, the last week of February spooked equity markets and many are now beginning to wonder if they were not overly optimistic in the *2021 Outlook*. Perhaps, they wonder, they did not interpret the signals in time.

The new Biden era brings politics back into the heart of the economy. And history teaches that when that happens, spending and borrowing are less controllable: monetary eases run by technicians are joined by fiscal ones in the hands of politicians seeking re-election. There's $1.9 trillion in incentives at stake to boost growth through digital development and the green economy. This is an opportunity for the market to see new investment as a business and no longer just a moral imperative to deliver a better environment for future generations. In order to transform production systems and ageing infrastructures, raw materials such as copper, iron, steel, cobalt, etc. are needed, the prices of which have begun to run with the relative consequences on the finished product. Some sectors, such as semiconductors, where supplies are stuck in a bottleneck, also due to Trumpian attempts at deglobalization, bring inflation. And Asia, for the first time in many years, has taken advantage of this to demand more of its exports, which are needed when in Europe and the United States the coronavirus still keeps economies on a leash. At the same time, however, thanks to vaccines, the exit from the pandemic can be glimpsed, especially in the United States. Growth, which has been suppressed for the past year, could then resume in a powerful way. If this happens, the bond vigilantes think, the Federal Reserve will have to raise rates sooner rather than later and so it is worth forcing its hand by selling bonds. Moreover, companies beat expectations in the last quarterly report.

But the Federal Reserve, like the European Central Bank, is convinced that there will be no structural inflation. But only a temporary price change due to pent-up demand in 2020, which will not find an adequate supply in the immediate future, and rising oil prices also due to the energy paralysis in Texas. Especially since they predicted that the market might doubt their vision. And it is no coincidence that last year Jerome Powell, head of the FED, announced that the institution he heads is ready to tolerate momentary inflation rates above 2%, convinced that there are structural forces that would bring them back to not far from the historical target anyway. Further confirming this analysis, Powell continues to keep expectations high for the $120 billion bond purchase per month. He promises that he will follow the unemployment rate (there are still 10 million jobless compared to the pre-pandemic period) and not the price rate as the main reference. The FED and the major central banks want to be so clear about this commitment of theirs that they cannot afford to discuss the risks that the large mass of liquidity causes in the stock markets: a miscommunication could be catastrophic.

But the GameStop case and the Bitcoin explosion still require a signal, an intervention. The bond vigilantes have understood this. For now, they are not fighting the Fed, precisely because the Fed needs them. They are allowing the markets to repress their excesses with a healthy portfolio rotation that sees Growth stocks losing and cyclicals and Small Caps winning, which will better benefit from the recovery, and Values (too much forgotten by investors). They are also helping to calm excess expectations on the greener sectors, such as solar, which have begun to discount too quickly a world that is not yet there.

On the downside it is therefore time to buy. But beware, now market indicators such as the price/earnings ratio are back in the news. It won't be long before the bond vigilantes return to their trench work, waiting for another moment to intervene. They will quell their ardours momentarily, because they know that overreacting now means pushing the Fed to control the entire yield curve. But they also know that the context has changed. With the planned stimulus, as Barack Obama's economist Larry Summers writes, the risks of inflation are more real. The real risk, for a change of scenario on the markets, will certainly be grasped by the bond vigilantes, but the real signal will come from the trend of the currency market. To be monitored with particular attention is the trend of the U.S. dollar, on which almost everyone is betting to the downside (over 230 billion short). If it should reverse its course because rates really rise (thanks to the bond vigilantes), or because the United States becomes such a growth pole that the risks of excessive debt are forgotten, or because of an unforeseen event, liquidity on the world markets could have strong repercussions. For now we will only have phases of volatility, waiting for the new balances between coronavirus, growth, stimulus and debt to become clear. But stock markets will continue to be supported. Even bond vigilantes know the adage "don't fight the FED".

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