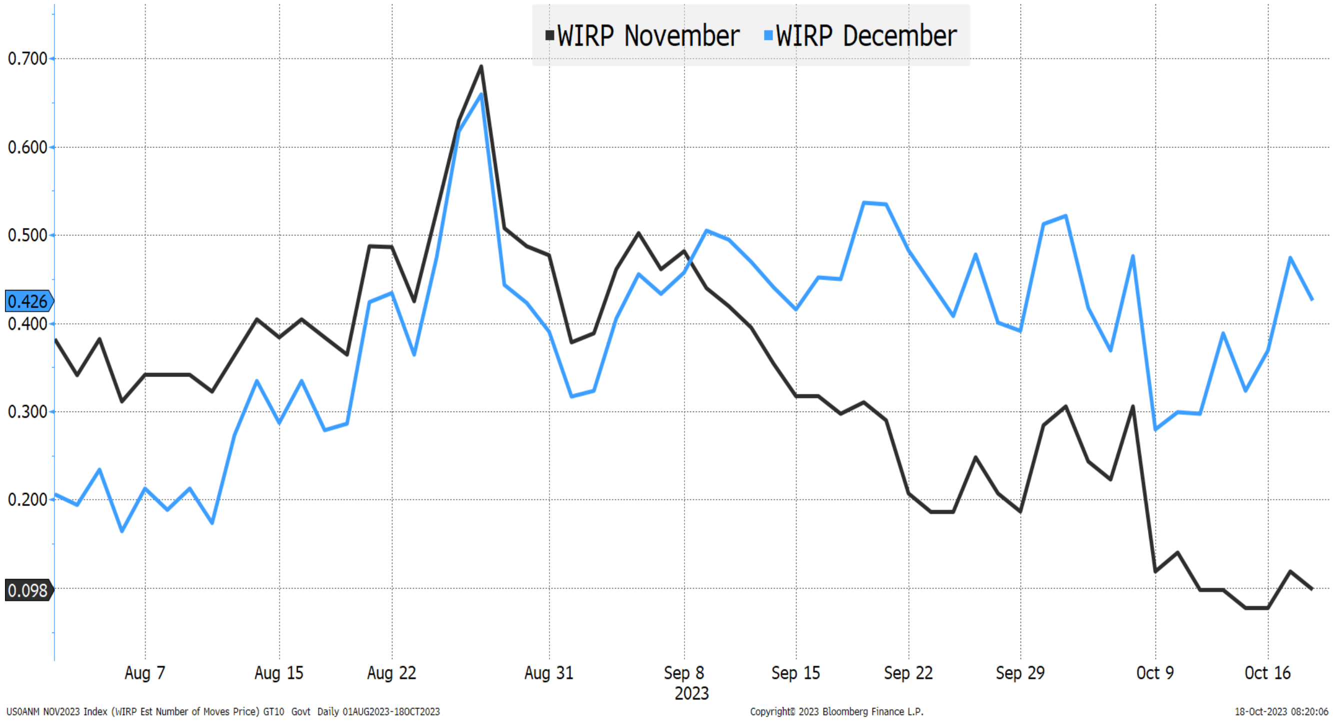
D.C Has Done the Fed's Job for Them (for better or worse)

We have finally heard a lot about real rates and are even starting to see more stories about how higher yields are really punishing small and mid-size companies (Sept. 13 – The Real Story is Real Yields). As discussed at the time, we had an inkling that this "story" was bubbling to the surface. We discussed how this affects not just the Fed, but also politicians. Many in Congress receive much of their campaign support from local businesses. As it becomes apparent that many small and local banks are in "balance sheet protection mode" (not looking to lend aggressively) and the private credit markets are much more expensive, it will hit politicians. The "boogey man" will not be inflation, but the concerns of local businesses (and campaign funding).

But enough on that subject or other "wonky" things about R*. Let's move to the main issue - **the rates markets have been hijacked by D.C.**



Since August, the markets have not priced a full hike between the November and December meetings. In late August, there was a 70% chance of a hike in November (that has dropped to a 10% chance). The probability of a hike in December has fluctuated between 30% and 55% since the end of August.

Yes, WIRP has shifted a bit further out on the curve (fewer cuts getting priced in), but **the reality is that the 30-year Treasury yield went from 3.8% in July to 5% in October because of something other than the Fed.**

The TIC data from China, showing that their holdings dropped from over $1 trillion in March to likely $800 billion by now ($821 billion was the end of July number) has certainly not helped. China is likely drawing down on their reserves to support their economy, but this shift from being a big buyer to allowing their holdings to run much lower has not helped yields.

But even that doesn't resonate (especially since Japan has recently been increasing their Treasury holdings).

The real story is that D.C. is now driving bond markets.

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Yields had bounced around for much of the year (between 3.5% and 4% on the long bond). Since the middle of July, they have been on a one-way street to higher yields.

We have seen a relentless push towards higher yields. While some of that is from the Fed's messaging of "**higher for longer**," the better/more realistic analysis is that **the rise in yields lands squarely at the feet of politicians, not the Fed.**

- **Downgrades.** While I don't think that the downgrades play a meaningful role (directly) in the yield moves, **the rationale for downgrades** (or threats of downgrades) is realistic. The U.S. is Behaving Badly as a Borrower.
- **"Solutions" that aren't Solutions.** We "solved" the debt ceiling (I think, though to be honest, I've lost track of that mess). But the solution didn't come with any concrete plans to address spending in a rational and well-thought-out way. Across-the-board cuts seem like a silly idea at best, and since they are in the future, the likelihood is that they get pushed out further and further until they can become an "election issue." I think that we averted a government shutdown, but for how long? Does it matter? **Very little coming out of D.C. suggests that anyone there is concerned about the trajectory of our debt (and that is disturbing).**
- **Monetary versus Fiscal Policy**. For much of my time on Wall Street, we've seen one scene play out in D.C. over and over: the Chair of the Federal Reserve being raked over the coals for what the Fed could do better for the economy. Then, at some point during the almost torturous, soundbite-driven questioning, the Chair has to point out that much of what is needed should come from fiscal policy (which is the purview of Congress, not the Fed's). It is a scene that has played out countless times. **I cannot wait for the first Fed Chair (possibly Powell) to tell D.C. that it is difficult to control inflation and bond yields when D.C. is on a spending spree, even while some of the data points to an economy firing on all cylinders**. Spending a lot in bad times made sense. It is "unclear" (to say the least) how spending a lot in good times helps address our debt problem when inflation is the real threat.
- **Supply.** The increasing supply of Treasuries being issued to fund this spending (and the interest

payments on existing debt) is concerning. The numbers are "staggering" or at least they are on the surface. Three things give me pause here:

- **"100s of billions of dollars" sounds like a lot of money** and makes for great headlines on nightly news, but in the grand scheme of things (measured in **trillions of dollars)**, it is concerning, but not alarming. We wrote about Maslow's Hierarchy of a Credit Bubble a few weeks ago. This heightened our concern that Bubbles Start with Safe Assets. But these things **generally take time to play out** and don't happen in one fell swoop. **Treasury supply is an issue but may well be overdone at current yields.**
- **Will IG Issuance slow?** Bonds are largely fungible. There is the ability, at least for some asset managers, to "substitute" IG for government debt. If IG issuance slows down (both in size, but possibly more importantly, in average maturity issued) then that will provide some respite from the onslaught of Treasury issuance.

Bottom Line

The Fed and Powell know that:

- The lag effect (made longer by Smart Borrowers) is kicking in, so they need to be cautious on how hawkish they sound.
- They have lost some control over the long-end and being hawkish will do little to fix that, at least not when it is fiscal policy concerns that are driving those bonds. Our fiscal outlook only looks worse as yields (and funding costs) rise.
- Geopolitical uncertainty is high and while the price of oil might be going higher, the risk of disruption to the global economy is a bigger threat and should make him hesitant to tighten monetary policy further.

Expect dovish comments across the board from the Fed ahead of the quiet period. OK, they will be somewhat hawkish because they must be, but not as hawkish as bond bears still think.

Do not expect any help from D.C., but the supply fears seem potentially overdone and any rally in Treasuries could trigger a lot of short covering in that market.

I still like Treasuries and risk assets, though my enthusiasm for risk assets is being curbed by the increased threats in the Middle East as published earlier today (link).

I'm looking forward to **Academy's 3rd annual Geopolitical Summit East in Annapolis** starting tonight and should have a lot of interesting takes from there.

Disclaimer