Confluence
INVESTMENT MANAGEMENT

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Transitory

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What 10-letter word begins with T, ends with Y, and is at the center of inflation discussions all around the bond market? "Transitory" is now of great importance in sizing up inflation, and, by extension, when and how the Fed may alter policy, particularly with regard to a second T-word, "tapering." The word "transitory" frequently gains relevance at points of change or inflection, oftentimes when assessing the longevity of an emerging trend. This tendency is palpable in the bond market today as investors evaluate economic growth, Fed policy, and inflation, while the U.S. moves into post-pandemic expansion. Interest in the topic is high enough that, according to Google Trends, searches for the word "transitory" were two to three times higher in early May relative to the previous five years.

Upward price pressure is unfolding on a variety of fronts, from housing to labor costs and even in certain commodities, including lumber and copper. If this type of inflation is a harbinger of other rising costs, and is the beginning of a long-term trend, bond investor wariness from the first quarter of 2021 may be quite well-placed. On the other hand, if recent inflation turns out to be episodic and cyclical, investors may find that multi-decade disinflationary trends remain in place and interest rates can remain low. Thus, determining whether or not recent inflation is transitory is of great importance.

One way to gauge long-term inflation expectations in the bond market is by evaluating the difference between the yield of a Treasury note and that of a similar-maturity Treasury Inflation Protected Security (TIPS), which is known as a breakeven rate that reflects expected inflation. The following chart illustrates the 10-year breakeven rate since 2008. Prior to the pandemic, the average was around 1.8%. Of course, the breakeven rate fell dramatically with the shutdown but rose quickly as optimism toward a recovery unfolded, crossing over 2% just as 2021 began. The 2% threshold (highlighted in red on the chart) is important because it is the Fed's long-term inflation target. Recently, the breakeven rate was just above 2.4%.

If bond investors are now pegging long-term inflation at a level higher than the Fed's own target, it is natural to wonder if the Fed is behind the curve in applying tighter policy. An age-old question is apropos: does the Fed lead the bond market, or does the bond market lead the Fed? In all our years studying the bond market, we've concluded the answer is: yes.

10-Year Inflation Breakeven Rate 2008-2021

(Source: Bloomberg)

The two parties are perpetually connected and it's difficult to know whether one party is pulling the other, or whether one is getting shoved.

Clearly, the Fed is aware of cyclical inflation. But it's also aware that short-run demand is more elastic than short-term supply. That is to say, demand for many goods and services can quickly rise or fall, while the ability to change available supply takes more time. Thus far, the Fed has concluded that recent inflationary pressure is principally transitory, recognizing through statements that, "some shortages may not be resolved quickly." As such, the Fed and the bond market remain at odds with each other. Bond investors expect that long-term inflation has risen above the Fed's target, while the Fed views recent inflation as transitory and not secular. For our part, we're more closely aligned with the viewpoint of the Fed. Global supply chains and technological innovation both respond to higher demand and rising prices, and the two exert substantial disinflationary pressure. And even though globalization and technology are growing increasingly out of favor, they remain intact for now and should limit secular inflation.

Tapering

"Tapering" is defined as gradually lessening or reducing, and against the backdrop of the Fed's balance sheet, this word is second in importance only behind "transitory." In the next chart, we update the Fed's balance sheet, which continues to grow in 2021.

The Federal Reserve Balance Sheet 2007-2021

(Source: Bloomberg)

Before the Great Financial Crisis (GFC), the Fed's balance sheet was less than $1 trillion, a level substantially below today's $7.8 trillion. Of course, the size of the Fed's balance sheet also reflects money supply in the economy, so some level of growth over time should be expected. Still, from 1990 to 2007, the size of the Fed's balance sheet relative to GDP averaged 5.7%, with very little variation. But the proportion changed dramatically during the GFC, rising into the 15-25% range, and today is over 36%. Part of the Fed's balance sheet expansion was needed to offset reduction in money velocity as consumers deleveraged; nonetheless, the proportion has raised inflation concerns, given the adage that "inflation reflects too many dollars chasing too few goods." (The Fed's balance sheet growth principally comes from incremental purchases of Treasuries and mortgage-backed securities, which it pays for by "printing" money.)

While the Fed can move with breathtaking speed to apply easy policy, it's adopted a protocol to be very gradual and to provide a lot of advance warning when it comes to removing easy policy or tightening. Therefore, we believe it's likely that the Fed will hold its balance sheet asset level steady for a while before actually tapering, taking a playbook from the 2014-2015 era.

Taken together, we're of the opinion that although inflation has emerged in certain pockets of the economy, the longer-term trend of low inflation should remain in place. If rising inflation is confirmed as transitory, the Fed will have more latitude to prioritize employment growth over inflation control, a preference it has already clarified numerous times. With all of this in mind, we

believe Treasury rates should be relatively stable and generally remain within the range experienced in recent months.

Corporate Sector

While certain sectors of the bond market, including Treasuries and high-yield bonds, have experienced substantial changes in sentiment in 2021, the investment-grade corporate sector has remained relatively stable, even as broader "risk-on and risk-off" trends ebbed and flowed across equities and bonds. Large volumes of capital have flowed into investment-grade bonds this year, but the rise in demand has been answered with substantial corporate new issuance. As a result, the trend in investment-grade spreads has been steady so far this year, as illustrated in the below chart.

Investment-Grade Spreads YTD 2021, Ending May 2021

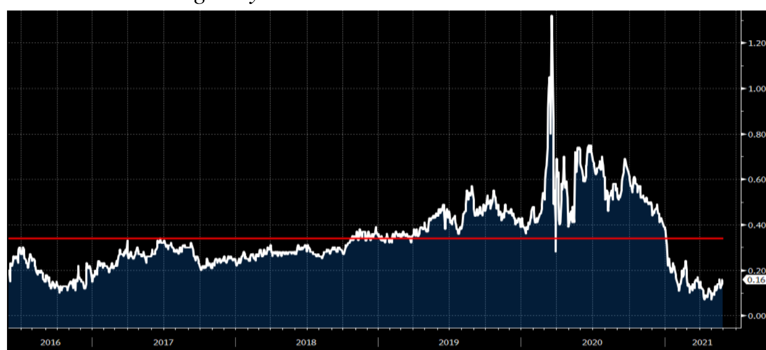
(Source: Bloomberg)

Like most sectors of the bond market, investment-grade corporate bond spreads are tighter than their long-term averages. This phenomenon is caused in no small part by the Fed's current balance sheet growth as the enormous amount of capital being injected crowds into all corners of the financial system, driving valuations higher. Still, tighter spreads in corporate bonds don't appear unreasonable, particularly against the backdrop of rising economic growth and a relatively benign default environment.

Mortgage-Backed Securities Sector

Mortgage-backed securities (MBS) continue to trade at expensive levels as measured by option-adjusted spreads. The following chart shows the five-year OAS trend, with the red line illustrating the average spread. Although some modest widening took place in the second quarter, spreads remain historically very tight.

Bloomberg Barclays Agency Fixed Rate MBS Index OAS, Five Years Ending May 2021



(Source: Bloomberg)

MBS and Treasuries are the primary securities the Fed purchases as part of its balance sheet expansion. Our next chart illustrates the composition of the Fed's bond holdings, with over $5 trillion in Treasuries (69%) and almost $2.3 trillion in MBS (31%). Accordingly, today the Fed is the primary determinant of MBS spreads. It is possible that when the Fed begins to slow its asset purchases it may proportionally curtail more MBS than Treasuries. If that were to happen, MBS OAS could widen and we may become more constructive on this sector. However, at current levels, we consider MBS too expensive and don't find the incremental return potential to be compelling relative to the embedded interest rate risk.

Federal Reserve Balance Sheet Composition 2007-2021

(Source: Bloomberg)

Municipal Bond Sector

Although municipal bonds are affected by the same disinflationary or inflationary forces that can propel or plague Treasuries, the ambiguity surrounding tax policy, infrastructure spending, and the use of fiscal stimulus has contributed to the continued elevation of municipal bond prices. This year has witnessed especially pronounced demand for tax-exempt municipal bonds by investors as the vagaries of maximum tax rates and treatment of state and local taxes (SALT) in the tax code are debated. On the supply side is a net subtraction of available municipal bonds owing to maturing debt combined with a lack of new issuance as state and local governments enjoy the fiscal stability offered through the stimulus plan passed in March. Further compounding the quandary of municipal bond pricing is the effect, if any, on state and local budgets of infrastructure spending as currently proposed. The sole certainty as it pertains to the municipal bond market is the historically low yield they offer relative to maturity-equivalent Treasuries, where AA-rated municipal general obligation bonds are yielding roughly 60% of Treasuries in the intermediate maturities.

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