The Market Forces Driving the Recent Asset Class Declines

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Thursday February 25th, 2020, all asset classes declined — bonds, stocks and bitcoin — while the US Dollar rose as a flight to safety. The sell-off was led by U.S. Treasuries as a 7-year auction was met with extremely poor demand. Even 5-year yields rose over 20 basis points ("bps") despite the U.S. Federal Reserve's (the "Fed") constant commentary that rate hikes are years away.

This seems different than anything we have seen since the 1980s, such as the big bond sell-offs of 1987 and 1994, when the Fed was raising rates aggressively in both those instances. It's also different from the sell-off in 2013 and 2014, when the Fed was talking about tapering quantitative easing.

Every market dislocation in the last 30 years or more has appeared to be a *growth* scare. This recent activity could be an *inflation* scare.

This time, the Fed is saying all of the same things about being on hold for years to come, but what has changed is that they are now focusing primarily on employment metrics and income disparity, the latter of which is new. The market is now fearing that this change will lead to out-of-control inflation at a time when valuations are extremely rich. In my mind, this is a valid fear.

The market is now trying to force the Fed to determine what 10-year yield on U.S Treasuries is too high and to use its balance sheet to establish a ceiling for the 10- and 30-year yields on U.S Treasuries. The Fed people are not traders and don't want to do this; the market is much bigger than the Fed and will win this fight. This means more volatility to come.

Now let's turn to what appears to be the cause: inflation scare. Inflation may rise in the next six to nine months as the big price drops of February, March and April 2020 fall out of the calculation and are replaced by the higher current ones. Other activity to consider is that the US Dollar declined 12 to 14% from March to December 2020, which continues to drive higher import prices. A weaker US Dollar also feeds into higher commodity prices and oil has nearly doubled. Core inflation may likely exceed 2% later this year, but it's unlikely to exceed 2.5% despite a couple of quarters of very strong GDP as the economy normalizes from COVID-19, assuming that actually happens.

The real issue is where inflation will be in 2022. The single most powerful driver of inflation is wages. The U.S. is currently reporting weekly new unemployment claims of 700,000 to 900,000 when the peak in 2008 was 650,000 to 680,000. The current unemployment rate is 6.3%, but the underemployment rate is near 12% and labour force participation is at near-record lows.

No matter what the Fed does, the unemployment rate is not going to 3.5% for years, and wage growth will be very weak.

The secular forces driving deflation are much more powerful than monetary and fiscal stimulus. Debt levels, demographics and technology replacing labour have been pushing inflation lower for three decades, and they are all much bigger forces due to COVID-19.

I don't know where the 10-year yield on U.S Treasuries will peak; It's already gone higher than I anticipated. Every move higher will destabilize equities further. But, this seems to be a case of inflation scare, not a case of a factual rise in inflation; that takes years.

At some point, there may be a huge bond rally, either because this turns into an equity sell-off and growth scare, or because inflation expectations start to recede.