Rodney's Take

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Someone Will Be Very Wrong

The U.S. Bureau of Labor Statistics reported that the economy added just 210,000 jobs last month. The market expected more than 500,000. At the same time, the unemployment rate fell to 4.2%, even as more people joined the labor force, which is a good sign. This conflicting information leaves the Fed in a bit of a pickle.

With fourth-quarter GDP growth estimates running 9% and unemployment near 4%, it looks like the economy is growing fast enough for the Fed to start taking its job of fighting inflation seriously. Transitory talk is out the window, and the central bankers are considering tapering fast enough to end their bond-buying program in April instead of June. This would pave the way for the Fed to raise rates at least once next year and probably twice.

None of this is controversial or secret, which begs the question, "What the hell is going on in the bond market?"

The 10-year Treasury bond yield peaked at 1.66% the week of Thanksgiving, and then rolled over as the markets sank on the omicron news. Today, with inflation running hot at more than 6% and GDP growth jumping, the 10-year Treasury yields a whopping 1.43%, which makes the real (inflation-adjusted) 10-year yield negative 4.77%.

Someone, or some group, is about to look pretty foolish.

It's possible that the central bankers are completely misreading the situation and, as Harry has noted, economic growth is about to wither as the stimulus spending during the pandemic wears off. If that's the case, then inflation should fall dramatically next year along with economic activity and the equity markets, proving that bond investors were right to keep interest rates exceptionally low.

It's also possible that inflationary pressures are real and persistent and that wage-push inflation is here to stay, as companies bid for workers and consumers prove they're willing to pay up for goods and services. If inflation sticks, then the Fed will have to do a lot more than stop bond purchases and raise rates a couple of times to affect the economy. Raising overnight rates from 0% to 0.50% won't do much. They'll have to raise rates above 1% to make a real difference. If this scenario plays out, then bond investors will have totally misread the economic tea leaves and interest rates will shoot higher in the months ahead to close the negative interest gap. We aren't likely to see the 10-year Treasury yield jump from 1.43% to 6.2%. Instead, long rates would rise as inflation eases a bit, and the two meet somewhere in the middle.

Given the amount of money sloshing around in the economy, I think inflation will be with us longer than anyone cares to admit and will nudge the bankers to tighten monetary policy a bit faster than they planned, which eventually should weigh on Treasury prices and push interest rates higher. This will pour a bit of cold water on the real estate market and stocks. But it probably won't last long. If, or rather when, the Fed sees the economy slowing down again, the bankers will reverse course and gin up the printing presses.

They have made themselves essential to the functioning of the equity and bond markets. If the Fed completely steps away, market participants will have to engage in true price discovery. With interest rates exceptionally low and leading stocks at stratospheric valuations, few people want to know the unmanipulated value of anything. Such pricing would be bad for their portfolios. So, when things turn ugly again, we'll quickly hear people call to bring in the Fed, and the bankers will be only too happy to oblige.

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Got a question or comment? You can contact us at info@hsdent.com.