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THE WEEKLY REPORT

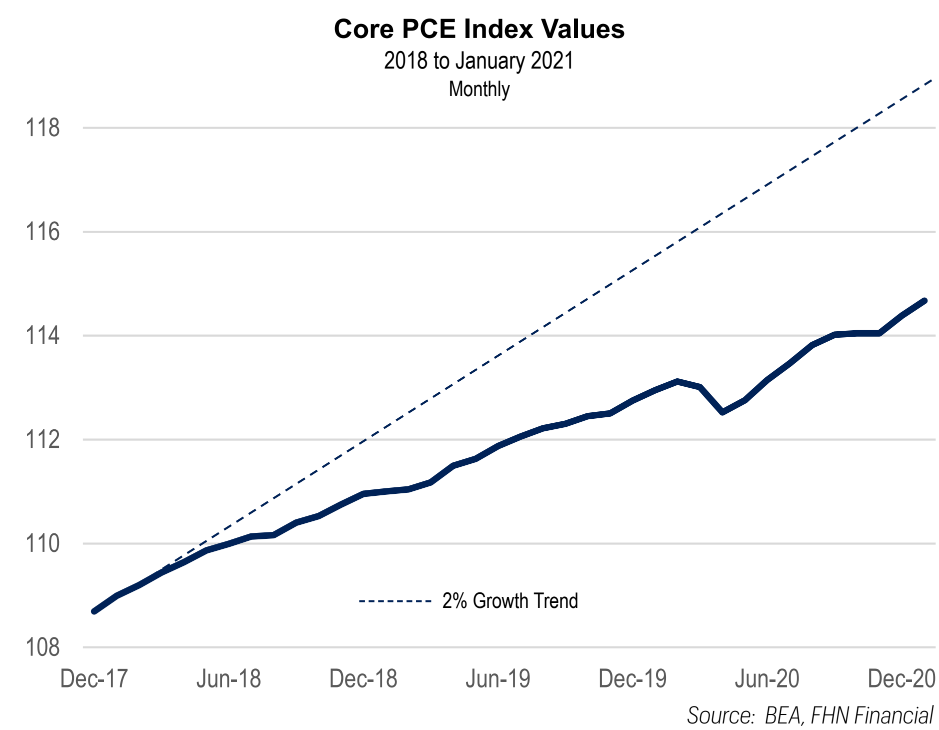
Bonds this week focused on confused trading and big questions for March, but inflation fears remain the subtext for interest rates this quarter. Most analysts have termed those fears a "reflation" trade. Yet, TIPS and the curve are not pricing a return to 2% inflation, they expect it to move to a new and higher range that begins at least at 2.30-2.40% and never retreats the rest of the decade.

It's difficult to call that simple reflation. The first article calls attention to the secular nature of 2021's inflation bet rather than a cyclical move.

January's core PCE prices rose .252% from December, rounded up to .3% in the headline. Gains the last two months reverse the very low measures in October and November. The 4-month average monthly increase is back to its low 2019 average.

The chart is a simple measure of how much faster inflation has to climb just to catch up and surpass Fed-targeted reflation. The dashed line traces 2% annual growth from the end of 2017, showing the gap created the last three years (starting at the end of 2018 produces the same trend). Its size is larger than the comparable differential for CPI, but PCE is the more important measure for policy makers.

The obvious challenge to bond traders is when PCE starts to close the gap, it will "confirm" not only reflation but the possibility of "runaway" inflation. Both conclusions will be incorrect for 2021-2022.



INTEREST RATES & DERIVATIVES P. 2

Progressively higher inflation expectations have detached from history, current fundamentals, and the Fed's inflation outlook. In the last four months, interest rates have risen with a principal focus on a rebound in secular inflation, not price changes tied to the macro economic cycle. Instead, the inflation component of term interest rates corresponds directly to the surge in risk assets above pre-pandemic growth.

MARKET UPDATE P. 7

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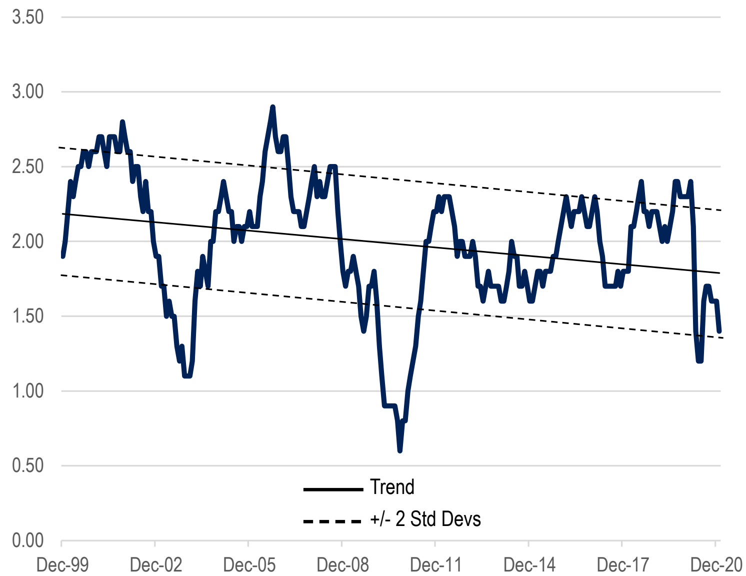
Secular Reflation Trade Dominates Rate Thinking

Progressively higher inflation expectations have detached from history, current fundamentals, and the Fed's inflation outlook. CPI forecasts generally follow US business cycles, the Fed outlook, and macro developments around the world. That has been the story for at least the last 13 years, and longer still based on this chart. Through January 2021, the trendline in core CPI is down.

Core US CPI
2000 to January 2021
Monthly



Source: BLS, FHN Financial

Even as inflation expectations have started to move sideways, they still ignited the spark that led to 10-yr UST peaking at 1.6% and 30-yr UST peaking at 2.4% this week.

In the last three months, interest rates have risen with a principal focus on a rebound in secular inflation, not price changes tied to the macro economic cycle. Analysts don't use the term secular inflation that often, discussing higher prices in terms of i) a post-pandemic recovery rebound in 2021, ii) last year's Fed policy change, and iii) this year's increased fiscal stimulus. Yet, the proxies for those themes do not correlate to the rapid rise in inflation breakevens. ***Instead, the inflation component of term interest rates corresponds directly to the surge in risk assets their above pre-pandemic growth rate. Where equities once were one of 3-4 variables in a robust model of the markets' thinking for price increases, they have become the only component.***

The S&P 500 is four standard deviations above a 5+ year trend that produced annualized returns of 10.5% in a global economy with less than 3% annual growth in GDP.

Source: Standard & Poor's, FHN Financial

The longer aggressive investors twin the risk-on trade with escalating inflation *certainty*:

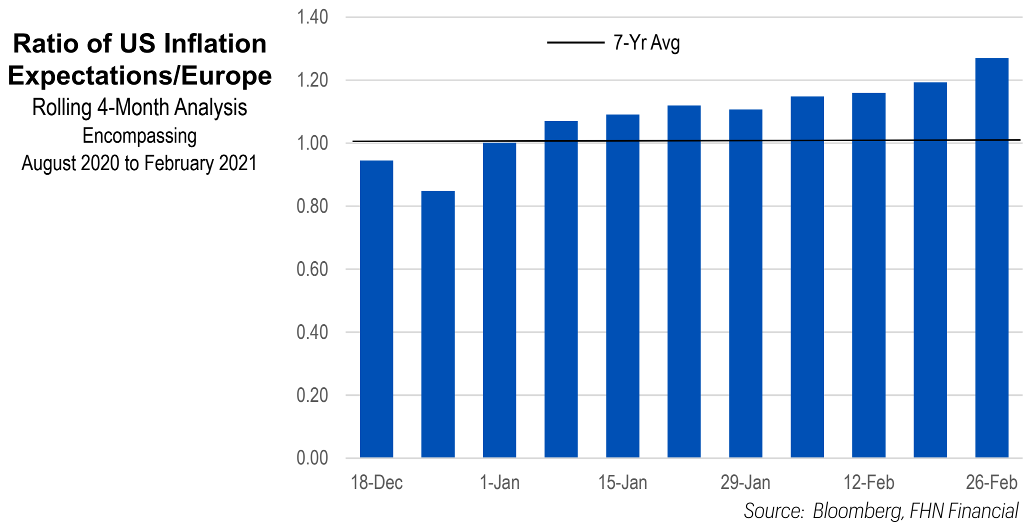
- The more sensitive rates will be to any whisper of inflation in the first half of the year. Inflation nerves already are on red alert, but they can reach a higher point. The same is true for any breath from the Fed about QE tapering.
- The threshold for bad news to keep yields under control will continue to ratchet higher. The tolerance for slips or slowdowns in 2021 already exceeds levels at any time in 2020 (or 2019, for that matter).
- The harder it will be to de-couple inflation concerns from stocks and other hot-running risk assets if and when the latter fall. If the confidence trade brings losses in global markets, the crash in US inflation expectations could be surprisingly strong – largely because direct support for CPI inflation in the bond market is narrowly focused outside most intermediate portfolio managers.

Bottom Line: Inflation expectations represent more than 100% of nominal interest rates. With prominent investors and analysts proclaiming a paradigm shift that will reverse the last two decades of modest inflation, bond market signals are scrambled for everybody. The error is trying to square current yields with current events and 2021 trends forecast interest rates based on traditional fundamentals.

US inflation's recent race to the top

A hallmark of the post financial crisis era was the development of global inflation. During the 2013-2019 recovery – and through the third quarter of last year – term inflation expectations in the US and the developed West moved in lockstep. Not only were the correlation statistics strong, but they moved together almost every step of the way. One basis point change in the price outlook in the US was matched with one basis point of price expectations in Europe. Then this fall, the ratio suddenly accelerated and has yet to stop.

The chart tracks the ratio from 4-month correlations.[1] The upward ratchet is an extraordinary move in such a short period of time.



Source: Bloomberg, FHN Financial

This major change is one of the markers of the supposed paradigm shift. The grid outlines selected highlights of the new themes that are pivoting from the last 10-25 years:

Selected Change in Interest Rate Paradigms

	Old	New
Breadth of Inflation	Global	US only
Fiscal stimulus	Short-term impact	Kicks off self-sustaining growth
Wage Trends	Controlled by globalism and innovation	Slower population growth
Marginal Pricing power	Large corporations	Labor and government
Consumer demand	Limited and price sensitive	Ratchets higher for several years. Little price sensitivity
Savings	Continued growth in cash	Cash is for losers
Investment spending	Tech and innovation	Infrastructure

Source: FHN Financial

The old paradigm is not just a set of qualitative descriptions. Low inflation also is supported by quantitative econometric analysis, principally from the Fed and the work embedded in the Laubach-Williams model that produces an estimate of the after-inflation neutral rate of interest (R*) that balances economic growth/employment and inflation. In considering inflation, the model examines three points:

- Economic output vs potential output – a measure of slack or constraints in the economy.
- Core PCE prices
- It takes out the influence of changes in energy prices and import prices to remove cyclical fluctuations from the analysis of price stability.

> ***The operation of the model is more important than its calculation of any particular value for R*. Low interest rates are caused by low inflation; low interest rates do not push inflation up.***

[1] The ratio is the beta of US expectations vs EU expectations from regressions that have $R2$ values of 80%-90%.

A closer look at when inflation expectations changed

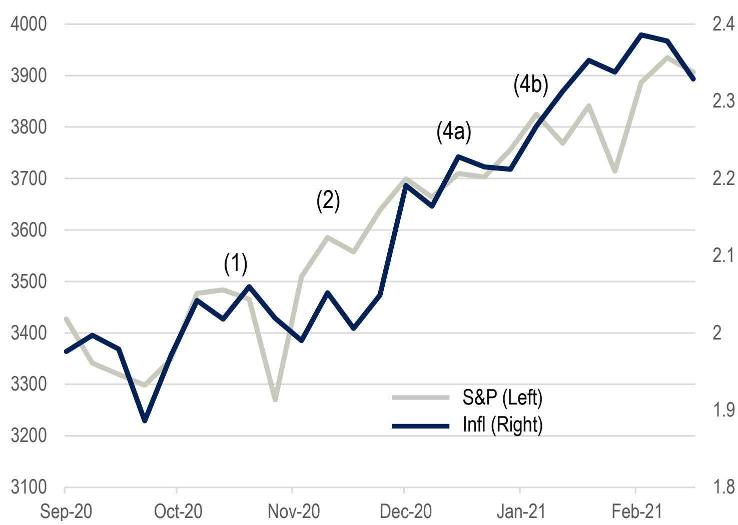
Sponsors of the reflation trade try, as mentioned at the outset, to tie it to developing and new fundamentals that warrant fear of cyclical inflation. They do not see their arguments as a new paradigm.[2] We need to look more closely, then, at our contention higher inflation expectations look like the market is pricing a i) secular change related to specific conditions this year that will trigger a ii) decade or longer of price increases that prove ruinous to bond investors.

The list of reasons for dangerous inflation include:

1. A solid foundation of demand despite the pandemic. Adding any stimulus on top of that foundation will create demand that exceeds production capacity, causing demand/pull inflation.
2. Renewed mobility after vaccinations this summer will release pent-up demand for services that will absorb labor capacity.
3. The Fed's new policy encourages inflation, stripping the brakes from the system that controlled inflation for three decades.
4. New leadership in Washington will borrow excessive amounts to accomplish first-year goals, adding stimulus just as vaccines start to work.

Take all of those propositions as correct and look at the timing of those developments. First, we concentrate on the side-by-side climb of higher US stock prices and higher 10-yr inflation derivatives. A daily chart would show an even closer relationship but it would be noiser.

S&P 500 and 10-Yr CPI Inflation Expectations
September 2020 to Present
Weekly



Source: Standard & Poor's, FHN Financial

2 More like the return of the paradigm from 1970s to mid-1990s, a period so long ago that going back that far actually represents the creation of a new paradigm.

1) With the September retail sales print clearly establishing a consumption rate above the pre-pandemic growth trend, the market concluded the worst of the broad economic damage was in the past. That data printed in the third week of October.
2) The promise of vaccines was on prominent display in the second week of November with Pfizer's efficacy news quickly followed by Moderna's. That week, it appeared Democrats would not control Washington due to a narrower base in the House and low odds of winning both Georgia Senate races.
3) The Fed's new policy on inflation is not on the chart because it was news the first week of August and then confirmed directly by Powell later that month. In an event/reaction timeline, it stretches the "rules" to say the market ignored something for 2-3 months and then started trading it. Using it as an explanation during the December – February increase of 30bp in inflation expectations feels like a by-the-way add on rather than a driver.

4a) The first stimulus is passed, but with heavy criticism by Democrat leadership it is undersized and would have to be increased in the first 100 days.

4b) The Senate 50/50 split provides a smooth road for a large stimulus package.

Since the middle of January, the "secular" inflation trade has gained momentum but few additional facts. Rather than present alternative facts to the arguments on page 4 here, there will be time to consider those at a later time.

Summary

During a sustained sell-off this week, short Treasuries repriced to imply the first Fed rate hike will arrive in January 2022. This Fed has a demonstrated capacity to change its mind and direction much faster than it did under previous chairs, but even that speed is too fast in light of clear statements from Fed leadership this week.

The insistent run of ignoring the Fed ties to the secular inflation idea highlighted here. Even with a pullback in rates – if the market decides to calm a bit – bond sentiment would still be poised to reverse again on the "inevitability" of price growth that sustains for the rest of this decade.

Premise of Intermediate Curve Stability Disintegrates

The Fed's central message of the last six months has collapsed under the weight of market-based conviction the stimulus may be good for many but is a death knell for bonds. Popular trades established on the premise the Fed would not hike until late 2022 at the earliest – primarily steepeners of several shapes and descriptions – succumbed to the panicky liquidation of rate risk.

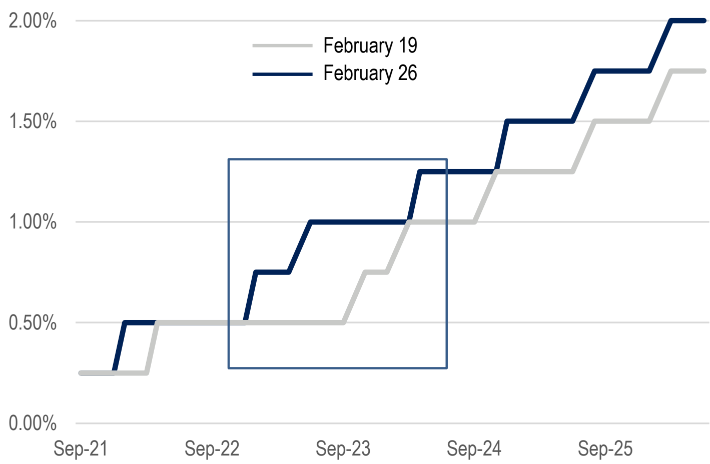
Offsetting short positions on longer maturities with longs at the short end – out to the 5-yr – can work this spring but not when losses in the 5-yr leg of the trade bring a rapid unwind of steepeners force many traders to exit at the same time.

Consider four mid-week triggers that set the collapse into motion:

- Equities liked Chair Powell's message of long-term support for the economic turnaround when he appeared before Congress Tuesday and Wednesday. Firm stock prices those two days – outside tech – gave macro traders another reason to sell bonds. Meanwhile, bond investors stepped back when selling accelerated because Powell also said long-term rates are not alarming – they simply reflect prospects for economic growth. The idea a 30 bp increase in yields in a month is "natural" would seem to work against the concept of quantitative easing.
- Influential NY Fed President John Williams threw more meat to the bears when he said Thursday afternoon the US economy may be on track for its strongest performance in decades.
- Mixed messaging from the central bank came in the middle of month-end discussions of how to square positions into March and the FOMC meeting on the 17th. Liquidity diminished, leaving rates to move higher on every marginal sale.
- Treasury supply thudded into the middle of a minefield. Few expected a good 5-yr sale, but 7s were supposed to be attractive based on steepening vs 5s and a yield above 1.0%. Cascading confusion sent potential bidders into hiding, and dealers owned a miserable amount of bonds in sloppy conditions. The auction was the sloppiest in recent memory. The post-auction price action, though, is now seared into traders' memory.

Compare the implied pricing of the Fed's target rate on Monday with levels after last week's sell-off. The highlighted portion demonstrates i) how much markets ignored core messaging already this month; and ii) how investors "hijacked" the narrative this week to a 1.0% target in June, 2023.

Path of Fed Rate Hikes Implied by the UST Curve
March 2021 to June 2026



Source: FHN Financial

The degree of uncertainty in the critical 2022-2023 period was obvious in the one-day spike in option volatility for 5-yr instruments on Thursday. It was the largest one-day move since the UST liquidity crisis in March, 2020. The weekly move was the largest since at least 2014 (when FHN Financial began collecting reliable daily numbers).

Implied Volatility on 1x5 At-the-Money Swaptions
Annualized Basis Points
September 2019 to Present
Daily

Source: ICAP, Refinitiv

Thin liquidity leaves yields to stab at random levels

10-yr UST are still the leading barometer of bond market sentiment, but this week the 5-yr UST was the main attraction. In the span of 24 hours, the yield range covered more than 25bp while senior Fed officials insisted they see no pending changes in policy. When the 7-yr auction essentially failed in the unwind of steepeners, traders were posting bids and offers to avoid trading. The confusion led to still more volatility.

5-Yr UST Yields
15-Minute Intervals
Noon of February 24 to
Mid-day February 26

Source: Bloomberg

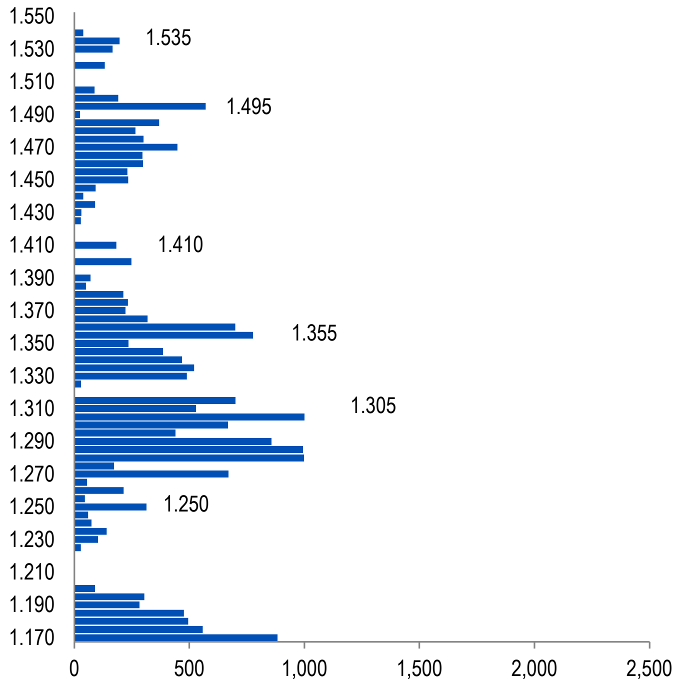
Poor liquidity stemmed from broken curve trades, but the failure of 5s/30s steepners clearly bled into intermediate curves – which are the heart and soul of value for many portfolio managers. ***The last two times when the 2s/5s curve broke this high this fast was following the November 2016 election and the spring 2013 taper tantrum.***

UST 2s/5s Curve
November 1 to Present
Daily

Source: FHN Financial

The dispersion of the volume traded at individual 10-yr UST yields also demonstrates the shotgun pattern of trades as investors tried to get close to targets. Volume is just since February 11, but the x-axis scale is set to the cumulative trading volumes that usually produce 10-15 bp moves over two months. Bottom Line: 10s do not yet offer reliable technical support levels. Resistance levels are clearer but are unlikely to provide helpful markers until the second week of March.

10-Yr UST Yields
With Volume Totals from Corresponding Futures Trading
Since February 11, 2021



Source: CBOT, FHN Financial
Note: Yield/Volume measured in 30-minute intervals

Fed tightening again dominates changes in rate components

Difficult trading conditions reduce the accuracy of yield attribution analysis, especially when it comes to discerning inflation expectation changes. Yet, the magnitude and direction of this week's analysis still rings through. The forward inflation curve should become more reliable the week of March 8.

	10-Yr UST		5-Yr UST	
February 19	**1.336%**		**0.577%**	
Infl Expectations		-0.060%		0.063%
Real Ylds (Fed)		0.155%		0.070%
Real Ylds (Supply)		0.040%		0.060%
Risk Premium		0.054%		0.030%
Liquidity		-0.022%		0.015%
February 26 mid-day	**1.505%**	0.167%	**0.815%**	**0.238%**

Source: FHN Financial

Financial conditions monitor

When the Fed thinks about economic pain from the rate increases this month, they look first at financial conditions. That discussion will be among the most interesting at the March FOMC meeting. There are several well-followed indexes that track overall conditions, and they have remained quiet so far this month.

The Fed is going to concentrate on any impact higher rates and curve shifts may have on i) mortgage financing cost; ii) bank lending and other household credit indicators; and iii) access of corporate borrowers to the bond market. The unusual 5s/30s flattening move could first present challenges to high yield where the wide open new issue market has lent critical support for many pandemic-hit sectors the last 4 months. If macro traders were caught off guard by the failure of steepening trades this week, high yield portfolios that target a duration of 3.6 years may be checking for damage from the 5-yr sell-off as well.

Remember, if everything is going well for the economy – a clear Fed statement this week – then spreads should <u>not</u> be widening. The move this week is at minimum, a sign of indigestion. This version of the CDX index looks at spreads.

High Yield Credit Default Spread Index
November 16 to Present
Daily

Source: Markit

A first warning sign would be a move back to 320bp on choppy bond market conditions but no change in sentiment about 2021-2022 GDP growth.

We will continue to add other monitors as necessary. There were no signs of general distress in the emerging market this week, thanks in large part to further declines in the dollar.

Summary

Aside from "what's moving yields now?" the dominant question from customers yesterday was "when will rates calm down?" The preliminary view is March 3 with "March 9 or March 10 a more likely answer. We have several strategy suggestions in the works, but are still aligning the specifics with three possible resting spots when yields and the curve find a range that produces two-way flows.

Curve twists to date have produced intriguing values in i) mortgages; and ii) callable agencies at a discount in the secondary. On a fundamental look, there are fresh opportunities in bonds maturing in 2025.