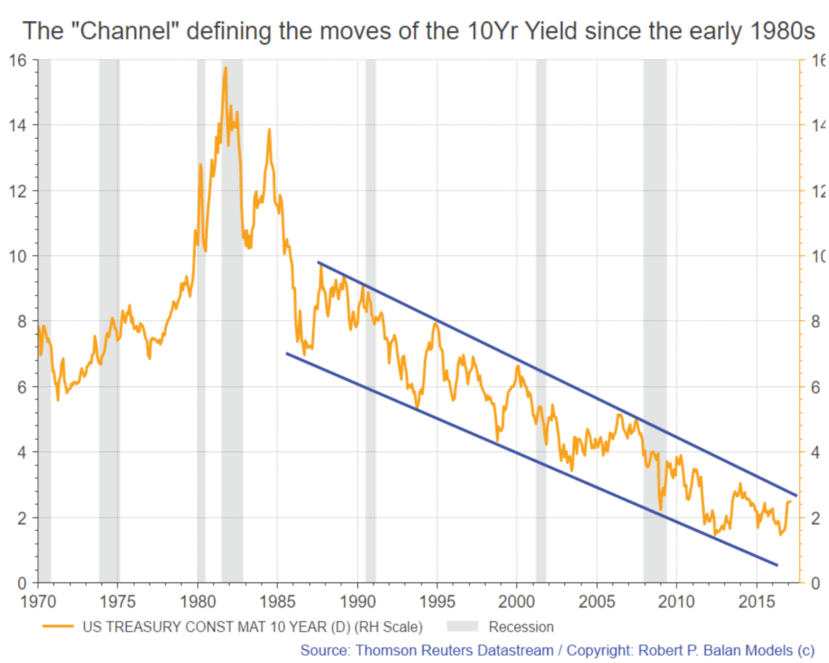
# 27/ Equity prices and bond yields moving contra to each other: look for liquidity factors to explain the moves

The yield on the 10 year Treasury bond has gone above 2.60 percent this week (prior to the FOMC meeting) -- a level «Bond King» Bill Gross considers to be a «tipping point» for future interest rate levels. He believed that if 10yr yields breached those levels, it means that the bond bull market has basically ended. In fairness to Mr. Gross, prior to the Wednesday´s FOMC meeting, it was an almost universal meme that long rates are going to rise, along with the policy (Fed Funds) rate. Mr. Gross has argued that the yield on the 10 year Treasury, once it broke the 2.60 percent channel barrier would soon jump to a much higher range. He was not alone – many others have also claimed that the era of low, longer-term interest rates connected with the Great Moderation is over. These sentiments are of course tied to the imminent rise in short term rates, after the Fed provided virtually explicit notice that policy will be tightened during the March FOMC meeting.

The equity market was not saved from speculations that rising rates will «destroy» valuation. The Nobel Prize of Economics winner Robert Shiller was also talking about the US stock market being overvalued, and the timing was suspiciously tied to the expected outcome of the FOMC meeting. Mr. Shiller was pointing out that his measure of stock market performance, the Cyclically Adjusted Price Earnings index or CAPE, is at about the same level it was before the stock market collapse of 1929, as well as rising close to the levels reached in 2000 after which the stock market corrected. The CAPE measure is said to provide an important measure of the quantitative valuation of current stock market prices, but no one can tell exactly what that might set off a correction, if at all. The almost-universal thinking was that the Fed tighter policy regime will push interest rates higher, probably beyond 3.0%, and that would cause equity prices to crash. Some analysts refined that argument, saying that if the increase in the yield beyond this level is due to a significant rise in actual or inflation expectations, this could influence the reaction function of Federal Reserve members and result in policy rate increases as actual inflation moved above Fed targets. Those speculations have not even come close in describing the performance of risk assets, post the FOMC meeting.

To summarize, pre-FOMC market expectations was for sharply higher rates and correspondingly lower equity markets. That is not what happened immediately after the decision was released publicly: longer term rates fell sharply, and the stock market rose. And the market considered the correlated move an artefact of the Fed´s statement, or for some, a conundrum. Is it? The situation is better understood as a liquidity issue. The Fed´s objective of having two more policy hikes in 2017 implied that systemic liquidity will remain accommodative. Note that the Fed´s previous definition of «gradual» tightening has been four tightening episodes in one year, so four hikes in 2017 could still be gradual in Ms. Yellen´s view. More so, Chair Janet Yellen said the Fed will continue to reinvest from maturing Treasuries and agency RMBS. This will keep the liquidity issue at the forefront. Why is this especially significant at this time? Models of liquidity flows have had success in tracking the movements of asset prices. Significantly, the models have tracked the gyrations in the stock and bond markets, pre-Brexit, before and after Mr. Donald Trump´s election as president of the US, and have mirrored the markets´ indecision during the days that lead to the crystallization of the Fed´s decision to tighten policy this week. More importantly, the models have successfully tracked the denouement of this week´s FOMC meeting (see the first two charts on the next page).

Usually there is a very high degree of seasonality, and thereby predictability, in the amount or scale of liquidity entering the US financial system, and the most significant ones are those originating from the Federal Reserve and the US Treasury. But since September last year, a massive amount of liquidity was infused into the system by the Treasury, for what seemed to be an effort to prime the markets ahead of the US presidential election (see last chart on next page). It did make a lot of difference as the equity market took off immediately before and after the election. Mr. Trump's win was used as an excuse for the "Trumplation" trades, but a rational analysis will show that the market rally owes its zing to the massive infusion of liquidity which was designed and intended



to help elect his rival, Mrs. Hilary Clinton. The election is now history, and so the US Treasury has embarked in an effort to offset all the liquidity that was meant to influence the election. The Treasury is leaving mere crumbs on the table after the mop up, and this will hurt the equity markets correspondingly after a short lag (see the red line on the third chart on the right). How will this impending disaster come about? The Treasury did not merely neutralize the liquidity surfeit during the election, but went overboard by using the withdrawn cash to pay for maturing bills and notes, instead of borrowing in the market as has been the standard procedure until now. An example was last year, during the same 47 day period which covered the withdrawal process, the Treasury funded mainly the operating deficit of 253$ billion by new borrowings of 157$ billion, which covered 62% of the shortfall. Its cash balance was 223$ billion on 7 March 2016, which compares with the cash balance of just 66$ billion last week, and targets 23$ billion – mere crumbs relative to the normal spending schedule of the Treasury. In fairness, the Treasury has had to cut its cash balance to 23$bn from 400$bn over the past three months, since it is not allowed to hold a buffer going into the debt ceiling's reinstatement. Ironically, by using its own cash to fund the operating deficit, the Treasury allowed the Fed dealers to keep the amount (which would be used to buy new debt issuance, otherwise), and will undoubtedly be plowed-back into the markets and should help support a rally to an April top. It is money that is going the equity market's way instead of going into the bond market.

But the sting is in the kicker – as cash holdings disappear, the Treasury has to resort to its emergency operating procedure: it has to borrow from trust funds so it can pay for maintenance. When the new budget of the Trump administration is approved, the Treasury will have to sell debt to pay the funds borrowed and to acquire funds to pay for government expenditures – to the tune of a ballpark number of circa 500$ billion. And it will be done in a matter of days. Government bond dealers will be hard-pressed to acquire wherewithal to finance the new paper issued by the Treasury. It is easy to imagine that equities and lower-grade assets will be sold by the bond dealers to accommodate the Treasury. We expect those dynamics to cause a sharp sell-off in the equity markets and a sharp decline in bond yields in late April. A large number of government bond dealers chasing paper offered by the Treasury at the same, in large quantities, should push up bond prices and depress bond yields sharply accordingly.