

Long Bonds And A Dovish Fed

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After last Wednesday's pivot by the Federal Reserve, the US dollar slumped, cyclicals rallied hard, gold and precious metal miners soared, and long-bond yields around the world, but especially in the US, fell. On the following day, the European Central Bank came out and essentially said "we don't know what the Fed is on about, but we are staying put". This contrast in messaging was arresting, given that US equity markets have flirted with new highs, US unemployment is close to record lows and US nominal GDP growth surged in 3Q23 even as Europe's economic performance has remained very weak. It offered up an unusual contrast which forces investors to mull over the following three possible scenarios:

1) Investors misinterpreted what Jerome Powell said and the Fed is not as dovish as they think. In this scenario, as the Fed reaffirms its "tighter for longer" mantra in the new year, the US dollar rebounds, long-dated yields probably rise and stocks most likely sell off with the possible exception of the "Magnificent Seven", which are increasingly becoming the natural recipients of any excess US dollars that non-US investors may hold.

2) The Fed is now signaling dovish because it foresees a slowing US economy. A skeptic could argue that the Fed did not forecast the recent surge in inflation and its forecasts for nominal US GDP growth since 2020 have been way too conservative. Hence, the fact that the Fed sees a possible downside to the exceptional boom it never saw coming may cause investors to take pause. Still, even a blind squirrel occasionally finds a nut, so it may be that the Fed is rightly cautious even if the ECB board is less worried in the face of far weaker data. But then, the ECB's track record at being late in both easing and tightening is itself pretty stellar! So if one wishes to conclude that the Fed is right to expect a slowdown, it is not that much of a stretch to again think that the ECB is "a day late and a euro short".

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US NAHB homebuilder confidence index rose to 37 in Dec, from 34 in Nov	Above 34 expected	Forward-looking components got a boost from the recent decline in mortgage rates
German IFO business climate fell to 86.4 in Dec, from 87.2 in Nov	Below 87.7 expected; business expectations fell to 84.3, from 85.1	Recession risk weighs heavy as Constitutional Court forced govt to tighten 2024 fiscal policy
Japan left benchmark rate and policy settings unchanged	As expected	Status quo on policy statement language suggests BoJ is in no hurry to exit easing stance
New Zealand trade deficit narrowed to -NZD1.2bn in Nov, from -NZD1.7bn in Oct	NA; imports (-15% YoY) fell faster than exports (-5% YoY)	Cooling domestic demand and softer oil prices contributing to narrower external deficit

Essentially, the Fed knows that a recession is looming and so loading up on long-dated US

treasuries makes sense. In this scenario, one should fade the commodity rally and perhaps even the dollar's weakness.

3) The bond rally is a knee-jerk reaction by a market used to bidding up treasuries when the Fed starts cutting rates. In the past, the Fed usually waited for equities to fall, or unemployment to rise or growth to roll over, before signaling its dovish intent. In that regard, a still-hypothetical Fed easing cycle would differ from its predecessors as it would likely be driven more by politics than economics. If this is right, then a pro-cyclical US monetary policy is likely to be very bad news for long-dated bonds. Next year could well witness very decent US consumption (boosted by the recent drop in oil prices), insane fiscal policies, a very tight labor market, a weaker US dollar and pro-cyclical monetary policies. This hardly seems to be the best of backdrops for investors in long-dated US treasuries.

As the reader has likely guessed by now, I am betting on this third scenario. Assuming that the Fed is sounding dovish more for political reasons than any genuine macroeconomic concerns, the next few months should see a weaker US dollar. If, at the same time, the Bank of Japan eventually abandons its negative interest rate policies and China's stimulus attempts start to gain a modicum of traction (and the People's Bank of China has ramped up liquidity injections of late), we could end up with a setup that is bearish for long-dated bonds across OECD countries, most but especially in the US.

Against that scenario, what could cause a further down leg in US long bond yields, aside, of course, from a faceplant by the US economy?

- Another purge in global energy prices? Given drought conditions in the Panama Canal and troubles in the Red Sea, such a benign outcome seems unlikely—at least in the near term. Oil is oversold, speculators have been washed out and positioning on the futures markets is very light. Meanwhile, the extension of shipping lanes to avoid the two choke points of Panama and Suez will likely mean higher fuel consumption and higher transportation costs for the Europe-to-Asia trade (to the extent that a big theme of our research is the economic integration of the Eurasian continent, troubles in the Red Sea are a setback).
- A resolution in the Ukraine conflict? To the extent that wars are inflationary, any end to the bloodshed in Eastern Europe should be welcomed by bond investors. At the very least, a resolution in Ukraine should mean less wasted capital on tanks, artillery shells and missiles. However, a peace deal would also likely imply significant needs for capital to rebuild Ukraine's economy. On balance, a Ukraine peace deal is one possible bullish development for US treasuries and other OECD bonds.
- A collapse in the Chinese economy and a devaluation of the renminbi? If China were to devalue meaningfully, it probably would have done so over the course of the past summer when the US dollar was soaring against most currencies. Instead, the PBoC drew a line in the sand and defended the renminbi and, having defended key levels, the exchange rate now seems to be ticking higher. Simultaneously, most of the economic data seems to show that Chinese growth bottomed out in 2Q23. While China's economy is hardly roaring back, the momentum is broadly, if meekly, pointing in the right direction.
- A surprise tightening of US fiscal policy—right before a presidential election? That seems unlikely!
- Another crisis in Europe? This is possible. After all, the massive undervaluation of the yen could cause problems for Europe's industrial firms. However, the unfolding issues in the Suez Canal and Red Sea could mean that shipping cars, machine tools, tractors or turbines from China or Japan to Europe will now be a more costly proposition. That could

give European manufacturers a little breathing room, at least until the yen starts to bounce back.

Failing that, with the US dollar index below its 200-day moving average, and the slope of the index now negative, I find it very hard to get excited about the near-term outlook for US long bonds.



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