Seeking Alpha α

My Highest Convictions For 2017: Higher Long-Term Yields And A Stronger U.S. Dollar

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by: The Fortune Teller

Summary

- FOMC minutes that were actually quite bullish caused long-term yields to move down.
- I have no clue where equity markets are headed but I definitely don't see a case to remain bullish.
- I do however see high conviction for higher long-term yields as well as for a stronger US Dollar.
- Debt and equity markets move in different directions for quite some time. Something gotta give and I believe equities eventually will.

FOMC Minutes - Bearish or Bullish?

Earlier this week, the Fed published the minutes from the December 2016 meeting following which the FOMC decided to raise the benchmark interest rate for the first time since December 2015.

The FOMC didn't used the word "Trump" even once and instead chose to use the words "Fiscal Policy". In regard to fiscal policy the FOMC members still see "substantial uncertainty" (we all do... perhaps even Mr. Trump himself...) but they clearly pointed at a higher probability for "somewhat tighter monetary policy than currently anticipated" if and when we see "more expansionary fiscal policy" from you-know-who.

Here are few quotes from the minutes (emphasis mine):

> Asset price movements as well as changes in the expected path for U.S. monetary policy beyond December appeared to be driven largely by **expectations** of more expansionary fiscal policy in the aftermath of U.S. elections

> most of the steepening of the expected policy path occurred following the U.S. elections, reportedly in part reflecting investors' **perception** that the incoming Congress and Administration would enact significant fiscal stimulus measures

Conclusion (=the way I read it) number 1: Basically, at the moment, it all comes down to expectations and perceptions.

The current expectation out of the Trump administration is to take three main actions:

- Spend at least $1 trillion on infrastructure projects.
- Cut taxes aggressively.

- Deregulation.

Those three measures may would lead to a short-term faster growth but also for a major longer-term headaches: Huge gap in funding, Unbalanced budget, Running a much higher deficit and most of all: Risk of a much higher inflation. The latter is what the Fed is mostly concerned of.

FOMC members not only raised their economic projections for 2017 but they've also very clearly stated that they might (already) be behind the curve, especially when it comes to unemployment rate and near-future potentially higher growth:

> Most participants attributed the substantial changes in financial market conditions over the in-between meetings period - including the increase in longer-term interest rates, the strengthening of the dollar, the rise in equity prices, and the narrowing of credit spreads - to **expectations** for more expansionary fiscal policies in **coming years** or to possible reductions in corporate tax rates

Conclusion (=the way I read it) number 2: The FOMC doesn't see these expectations as temporary or short-term lived. Instead, they fear of a very loosened fiscal policy throughout the entire (at least first) presidency term.

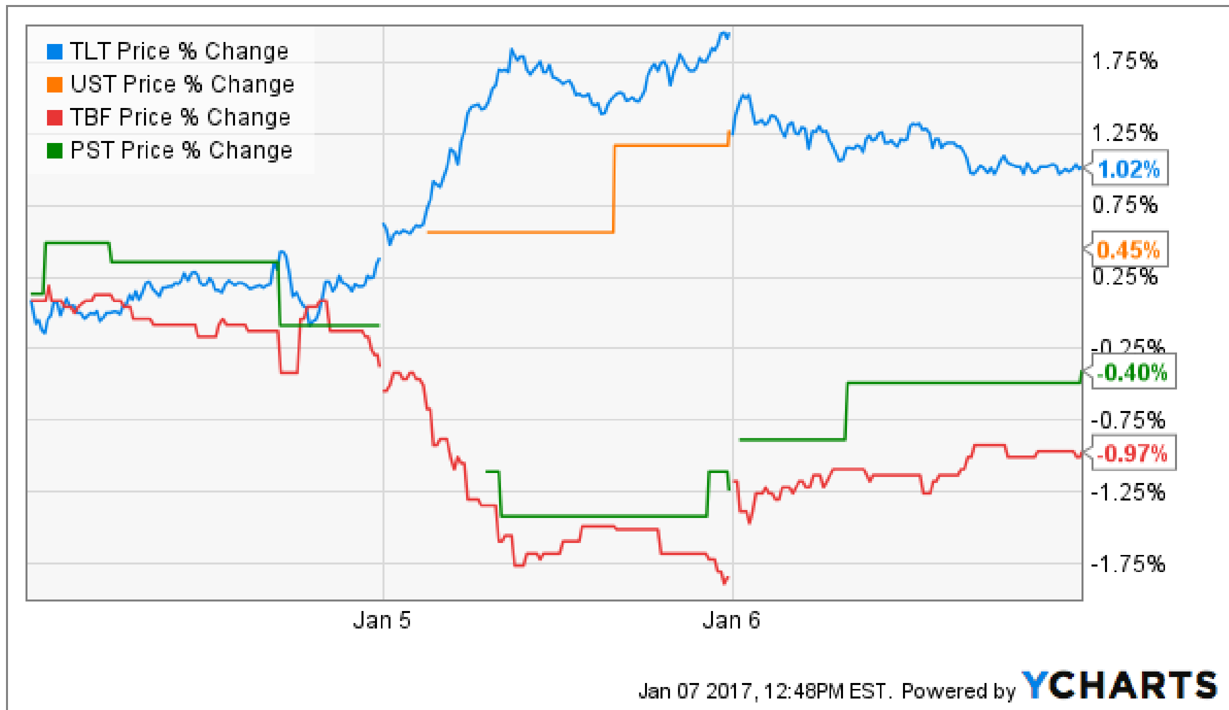
Moreover, most FOMC members "also indicated that the upside risks to their forecasts for economic growth had increased as a result of prospects for more expansionary fiscal policies in coming years".

This is exactly why the FOMC has updated the number of expected interest rate hikes from two to three, stating that the expected moves by the new administration are "posing upside risks" to their own projections.

The FOMC now speaks about "gradual normalization of rates".

Conclusion number 3 (=the way I read it): Three expected hikes in 2017... for now. It may be even more should Trump actually meets all expectations.

All in all, I must admit that I view the most recent FOMC minutes as bullish, definitely not bearish. Nonetheless, this is how long-term yields have reacted to the minutes (published on 1/4/2016):



Medium-Long term bonds ETFs such as TLT and UST rose while inverse ETFs such as TBF and PST sank. Very strange indeed.

I'm long TBT - the long-term Treasury bonds inverse ETF - and this (or shorting the TLT) is one of my main conviction for 2017.

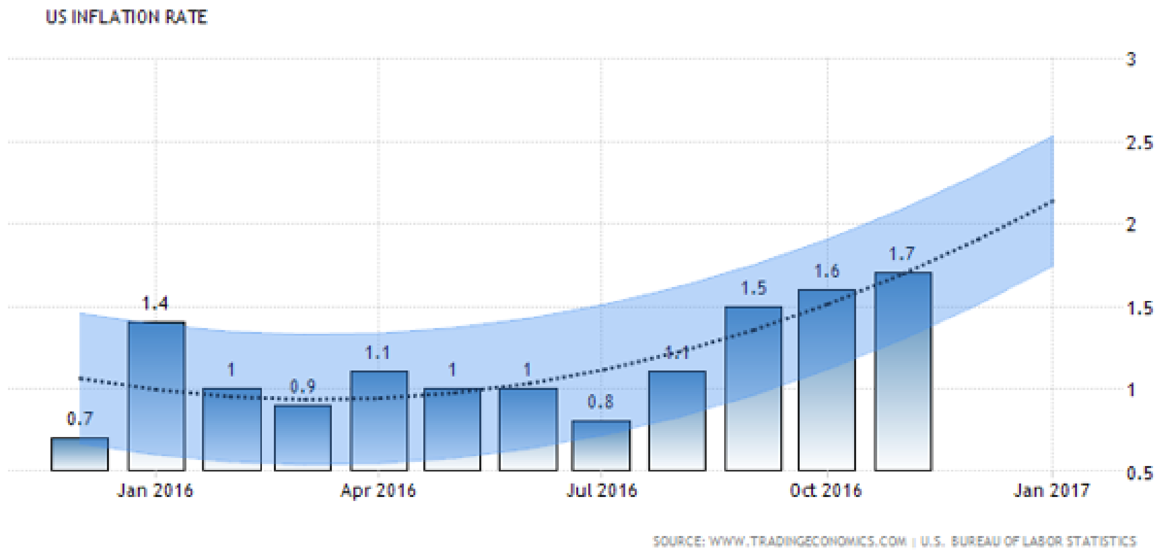
Inflation: Here I Come?

Fed members pointed out that the inflation pace already picked up mainly due to rising energy prices. Yet, they still expect inflation to remain "marginally below" the 2% target for at least another two years.

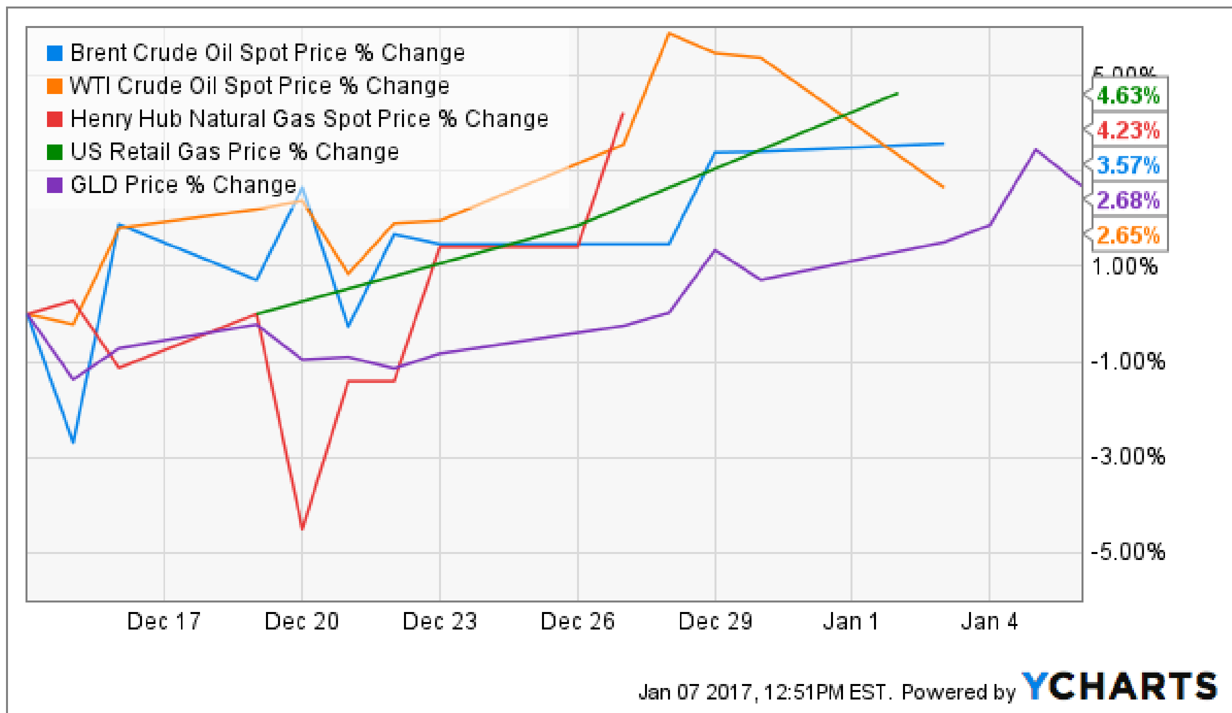
On one hand, the FOMC clearly stated that the decision to raise rates in December was partially due to "sufficient progress" in inflation moving towards the long-term 2% target. On the other hand, they expect another two "below target" years.

Conclusion (=the way I read it) number 4: The December hike was entirely due to you-know-who. Inflation wasn't a real factor in the recent hike but it might very well be if the "sufficient progress" turned into "significant progress".

At the moment, the US inflation (TIP, VTIP) still runs at a pace that is below the Fed's 2% target but it's not too far off anymore. Furthermore, if we look at (or draw a line of the) future-expected rate of inflation (RINF) we can clearly see that the 2% is within reach in the near-term future:



The Fed, already worried in mid-December that it's behind the curve, should be even more worried now because energy (and many other raw material) prices have spiked since the Fed concluded its last meeting on December 14th. Take a look for yourself:



If energy prices (OIL, UCO, UWTI, GAZ, UNG) were a concern a concern regarding a higher inflation back in 12/14/2016 they should definitely an even greater concern now.

Prices of many raw-basic materials (NYSEARCA:XLB) and metals - especially precious metals, e.g. GLD, IAU, PHYS, SLV, PSLV, PALL) - have rose too so the overall picture is even more inflationary than energy prices draw on their own.

The Impossible Dream in 2017?

One of my favorite authors here, Eric Parnell, concluded in his recent "The Impossible Dream In 2017" article with the following words (emphasis mine):

> The market has set out an ambitious interest rate raising program for the Federal Reserve in 2017. Unfortunately, the market has set expectations for something that remains without precedent. As a result, the risk is high that the Fed will end up falling short of current market expectations when it comes to interest rates. In fact, the Fed may end up coming up well short of current projections by this time next year. Of course, the risk of something not playing out as expected leaves open opportunities for those that are anticipating the different outcome in advance.

Then I asked Eric, based on what I viewed as relatively bullish FOMC minutes, doesn't he feel that it's the other way around, i.e. perhaps the market is pricing in too fewer rate hikes? I added that if Trump goes on with everything he plan (or assumed to plan...) the hands of the Fed will be tied up. They will be forced to tighten the monetary policy in order to fight a very loosened fiscal policy.

Here's how Eric replied:

> You are absolutely right that the opposite may be true in that the market could be underestimating the Fed at the start of the year. But at present, Fed Fund futures are giving an 11.7% probability to at least four quarter point rate hikes this year (this includes a 2.3% probability for five and a 0.3% probability for six). The fact that all of these probabilities are greater than the odds that the Fed won't hike at all or end up cutting rates before the year is out to me suggests if nothing else that the market may be ahead of itself in its bets on what the Fed may do this year even despite today's minutes.

Fair enough but even Eric leaves some room for the possibility that "the market could be underestimating the Fed".

It all comes down to what extent will Mr. Trump delivers and meets the high expectations of everybody, including Fed members. I believe that there are good chances for at least 50% of the expectations to be met but that would also leave us with the glass half empty as ~50% may not get filled.

The main difference between Eric and I is the distinction between the percentage of expectations that are going to be met and mostly timing. While Eric see Trump actions only having possible effects beyond 2017 - I believe that the "meet the expectations" factor would set the course throughout 2017.

Putting it differently, it's **because** of the implications of whatever Trump will be **doing** only starting to be felt in 2018 (at the earliest) that I believe the **words** (that build up expectations) would lead the way in 2017. As we all know, Trump is pretty good at expressing himself at all kind of ways and words are one of his most powerful tools. Therefore, I strongly

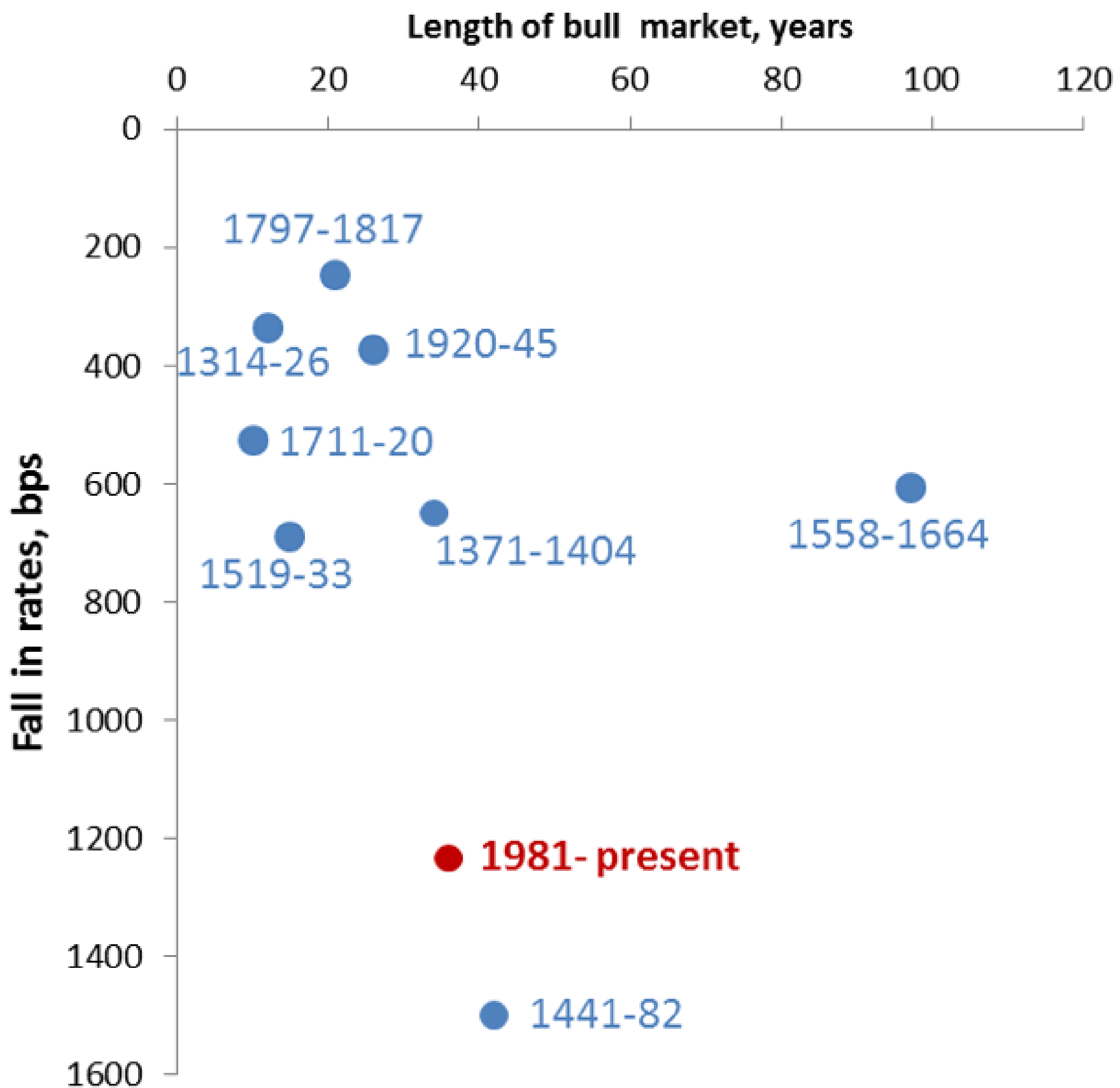
believe that the implications on the markets, rates, yields and US Dollar (UUP, UDN) would be significant in the short-term, surely inside 2017.

2017 is going to be driven by the verbal policy, not by fiscal policy (and the former may be way more powerful than the latter!)

Bond Shock: A Perfect Storm?

Paul Schmelzing (a PhD candidate at the Harvard University who specializes in economic history) threw a bomb earlier this week through the Bank of England's blog (Thanks to Dividend Retriever for sharing this with me).

In a nutshell, he is claiming that the debt markets are facing (what he calls) "a perfect storm".



Using the above chart, Mr. Schmelzing claims that the 1980-2016 bull run for bonds is "one of the largest ever recorded" and that "only two previous episodes - the rally at the height of Venetian commercial dominance in the 15th century, and the century following the Peace of Cateau-Cambrésis in 1559 - recorded longer continued risk-free rate compressions".

Mr. Schmelzing concludes with the following statements:

> History suggests this reversal will be driven by inflation fundamentals, and leave investors worse off than the 1994 'bond massacre...
>
> ... In the current environment, the combination of a steepening bond-yield curve, Fed tightening and inflation could have painful implications for investors
> By historical standards, this implies sustained double-digit losses on bond holdings, sub-par growth in developed markets and balance-sheet risks for banking systems with a large home bias

Once again - just as I've shown before - inflation is becoming an issue. Not only for the Fed but for the debt markets.

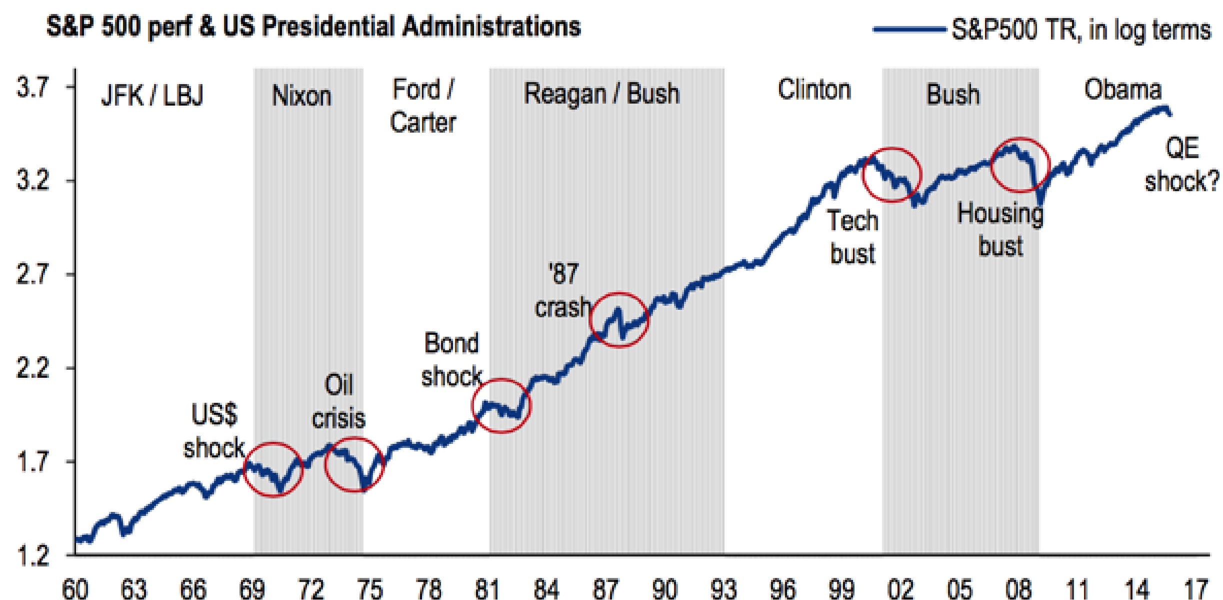
Danger Ahead?

My previous article dealt with the <50% probability for 2017 to be another positive year for the S&P500 (NYSEARCA:SPY). In light of these views, I'm adopting a very conservative approach that I've demonstrated through my A-Team versus H-Team actual strategy as well as through the fifty shades of pair trades that are part of a theoretical long-short strategy.

The very productive discussion that was going through my last article thread involved a bit more than usual (for my articles) politics and "Trump talks". That reminded me of the excellent piece that Business Insider published (just over a year ago) with the title: "The end of a two-term president is usually bad news for the stock market"

In this piece, Business Insider used a note that was to clients by Michael Hartnett and his team at Bank of America Merrill Lynch. In their note they wrote that "2016 should be another tough year for markets, another year of 'deflationary expansion,' and a perilous transition to the promised normalization of Higher Growth & Higher Rates."

Here's the troubling chart that was used to demonstrate the relationships (over the last 55 years) between presidential terms, the S&P500, and potential/real bubbles that were developed along those terms:



Surely the guys from BoAML missed it for 2016 (although in the first few weeks they seemed to be spot on) but their warning is very much valid and technically Mr. Obama is still the president so we are still within the "end of the second term".

Joke aside, the above chart beautifully illustrates the many challenges on one hand and the "danger zone" on the other hand that are facing any administration change. While BoAML warning hasn't materialized in 2016 it surely can in 2017.

Combining the warnings of Paul Schmelzing and Michael Hartnett warnings should sounds quite a noisy alarm.

The Very Probable Themes in 2017

I have no idea where equity markets are heading. I do, however believe that:

1. We will see the S&P500 moving up or down more than 10% inside 2017 but not necessarily from the beginning point (1/1) to the end point (12/31). Therefore, I maintain a very cautious stance while leaning more and more towards bearishness.

2. The odds are not in favor of the S&P500 recording another positive year. It may but I rather play the long-term based on probability and if it means that I miss on a great year - let it be. When we measure long-term cycles, say 10 year timeframe, one or two years are not as important as the other eight-nine years. It's a fact that the past eight years (2009-2016, inclusive) already been great... what is neither a fact nor a good bet is to assume that the next year or two will look exactly the same.

While I have no high conviction regarding equity markets, it's clear that almost everything is playing against debt markets. I have high conviction that bonds prices will continue to fall, even if a "perfect storm" won't blow in our face.

It's enough for inflation to pick (up pace) and for Trump to speak (up pace too...). Those two elements would lead for further - and perhaps even faster - monetary policy tightening, simply because the Fed hands would be tied up. They will have to fight inflation (that may get out of control) on one hand and a fiscal policy (that may get out of control) on the other hand.

I'm also bullish on the US Dollar. Higher inflation, higher short-term rates, higher long-term yields - that leaves very little room to doubt the ability of the greenback to keep strengthening against all major currencies.

... Not to mention a run to safety that may be caused by currency war, trade war, political conflict or a major act of terror. It's very likely that something ,somewhere, sometime would lead to a further US Dollar boost.

Bottom Line: You Have Nothing to Lose...

To sum it all up, I would claim that there are many unknowns and an extreme level of uncertainty. Nonetheless, there are two elements that clearly stands out of the pack: **Inflation rate is picking and the "Trump (verbal) bomb" is ticking**.

As a matter of fact, adopting the themes that I have high conviction for is a very low risk play. If I turn to be right - that's obvious.

As always, it all comes up to the Fed but Fed members already admitted that full employment has already been achieved. Furthermore, the most recent employment report indicates that wage growth increased at 2.9% Y/Y - the fastest pace since 2009!

While Eric Parnell may not see the Fed hiking three times this year, I see a possibility for the Fed doing that... and then some more... Currently, the short-term rate futures are pricing in (with a high probability) only two (not three!) 0.25% rate hikes during 2017. It surely looks as if the market - not only the Fed - is behind the curve!

The beauty of these themes is that even if I turn wrong - and there's a 50% probability for that to happen to... - long-term yields and the US Dollar will spike higher too. Unlike my underlying (negative) reasons this time it will happen to underlying positive reasons: higher growth and/or better economic data and/or Fed on hold, etc.

There's not much to lose here... or at least so I believe...

Disclosure: I am/we are long SPXU, TBT.

I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.