Steepening US Yield Curve Is a Harbinger of Inflation That'll Oblige Fed to Tighten

Prasenjit K. Basu

EXECUTIVE SUMMARY

The steepening yield curve reinforces our view that the US$900 billion stimulus enacted at end-2020 will largely close the US output gap in the current quarter. The new Biden stimulus of US$1.9 trillion (pushing this year's fiscal deficit to a post-WWII record of 20% of GDP) will render further monetary stimulus superfluous. The Fed will be obliged to rein in QE in 2Q 2021, and actual raise the Fed Funds rate no later than its July 2021 meeting. We are bearish equities on a 6-month view, and bullish the US dollar.

We reiterate our view articulated in December 2020 (2021 to Mark the Return of Inflation: Fed Hike by Mid-Year Implies Risk-Off by 2Q/21 elaborating on our June 2020 view Labour Market Slack Remains but FOMC Will Need to Tighten by Mid-2021) that US core PCE inflation will begin to tick up toward 2% YoY by mid-2021, obliging the Fed to cut back on the size of QE, reducing its monthly purchases from the US$120 billion that it has promised. In January 2021, US base money grew by US$41 billion (much less than the promised figure), but this sufficed to boost M2 by 25.5% YoY: we observe that 24% YoY M2 growth (more than double the peak pace of M2 growth in 2009) has become an implicit target while core inflation is subdued and labour-market slack remains.

The US output gap didn't close as much as expected in 4Q 2020 because of the spurt in Covid-19 infections, but the likely passage of Biden's US$1.9 trillion stimulus package (on top of the US$900 billion package enacted at the end of 2020) will cause the fiscal deficit to hit a record 20% of GDP in FY2021. The previous stimulus is likely to largely close the output gap in the current quarter (with real GDP likely to be only about 1% below its potential) based on the December 2020 stimulus. A further massive fiscal stimulus will make the Fed's QE superfluous.

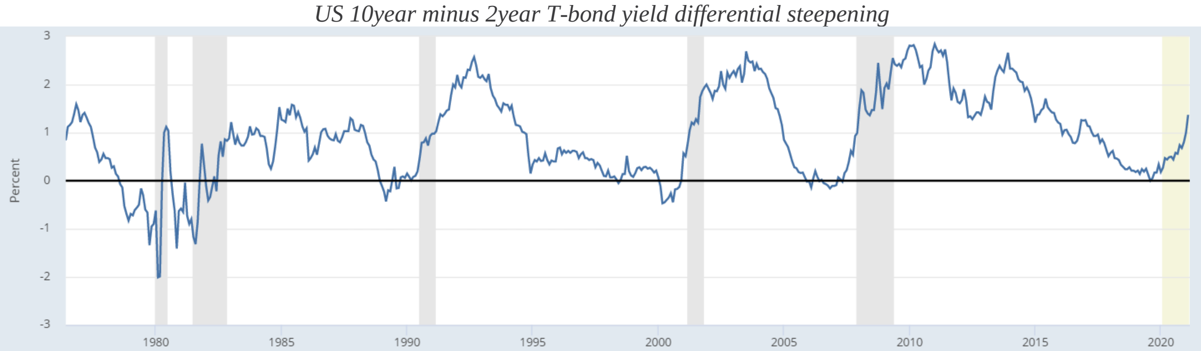
Inflationary expectations (as reflected in the 5-year TIPS/Treasury breakeven rate) are already for average inflation of 2.4% over the next 5 years. When a further fiscal stimulus pushes this year's fiscal deficit to a record 20% of GDP, core PCE inflation will quickly print above 2% YoY, obliging the Fed to cut back on its promised monthly QE during 2Q 2021, and to actually raise the Fed Funds rate by its July 2021 FOMC meeting.

DETAIL

The US yield curve has steepened sharply -- with the differential between 2-year and 10-year bond yields rising from 0.8pp at the end of 2020 to 1.37pp now (i.e., a steepening of 57bp in less than 2 months, and 11bp in the last 2 days; chart below). Essentially, while short-term rates and yields have been stable, longer-dated bond yields have risen -- with the 10-year yield rising from 0.92% at end-2020 to 1.5% on 26 February 2021, while the 30-year bond yield has risen from 1.65% at end-2020 to 2.24%. (Notably, the 10-30 yield curve has remained unchanged over the period, suggesting that longer-term growth and inflation expectations remain stable).

The 10-year minus 2-year yield curve is at it steepest since October 2015, suggesting the likelihood of a sharp acceleration in nominal GDP growth. The bond market has started pricing in a robust economic recovery within two years -- but clearly still believes Fed chair Jay Powell's assertion (repeated this week) that interest rates are unlikely to rise before 2023.

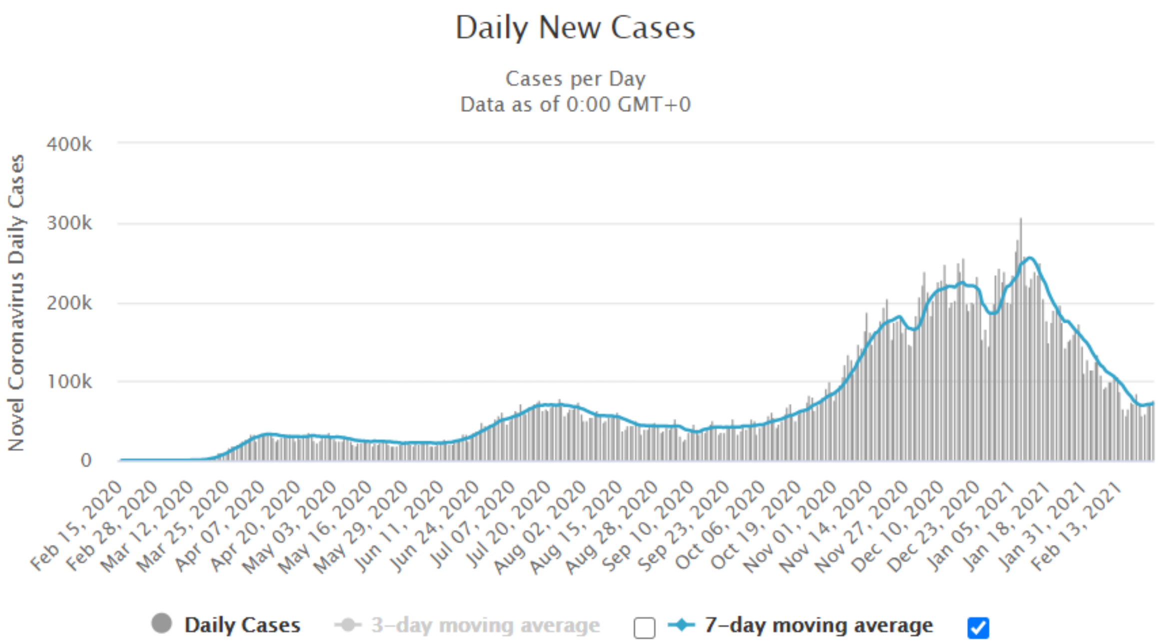
US 10year minus 2year T-bond yield differential steepening



Source: Federal Reserve Bank of St. Louis (the recessions are marked in grey, including the current one)

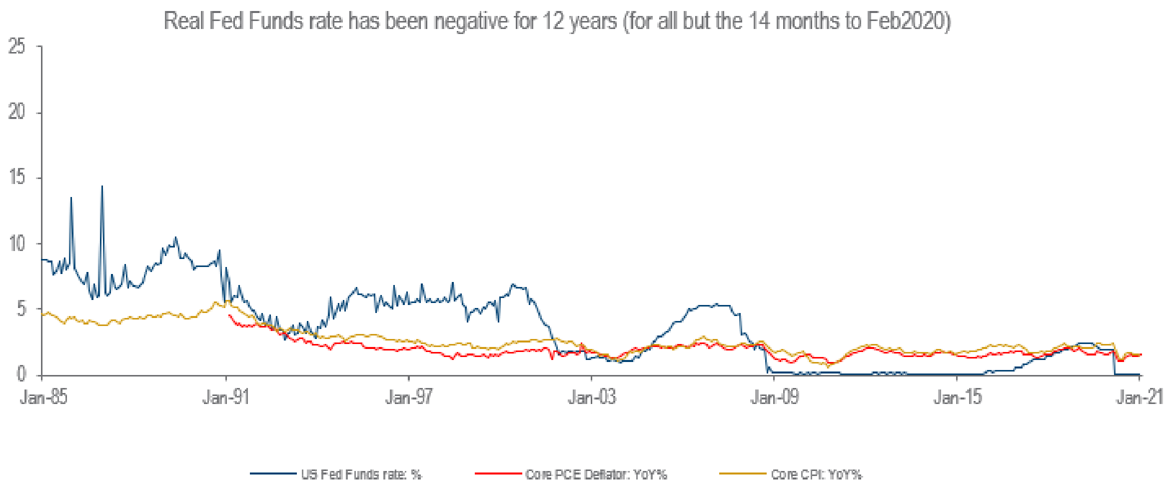
A key factor contributing to improved expectations about US growth is the sharp improvement in the Coronavirus situation in the US. The 7-day moving average of new Covid infections in the US peaked on 11 January 2021 at 255,311 (chart below), moderating to 69235 cases in the 7 days to 21 February 2021, before edging slightly up to 71412 on 25 February 2021. Although a vast improvement after the huge spike in December 2020 and early-January 2021, the toll of new infections in the US has flattened at levels that prevailed just before the US election. This implies that the economy can slowly resume functioning with social distancing -- after renewed lockdowns and closures over the past 2-3 months -- but it cannot be fully functional. With 21.55 million people (6.57% of the US population) fully vaccinated against Covid, and 46.07 million (14.04% of the population) having received at least one vaccine dose by 25 February 2021, the US has made considerable progress toward achieving herd immunity -- which should be achieved when at least 80% of the population has been fully vaccinated (i.e., likely by mid-2021). [The WHO has not determined what proportion of the population needs to be vaccinated in order to trigger herd immunity against Covid: for measles, the estimate for herd immunity is 95% vaccination, while for polio it is 80%].

Daily New Cases in the United States



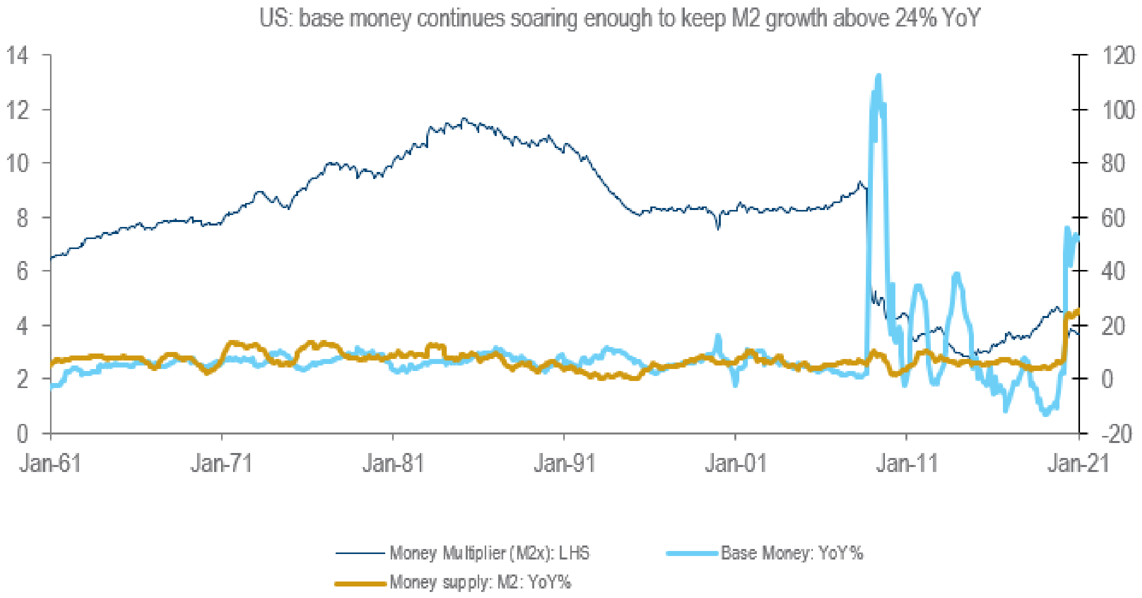
Source: Worldometers.info

Output gap keeps core inflation tame, but inflationary expectations have moved decisively higher this month. Given the still-large output gap, and slower recovery in 4Q2020 (+4.1 QoQsaar growth), core PCE inflation (the FOMC's preferred inflation gauge) barely edged up to 1.5% YoY in January 2021 -- and core CPI inflation edged down to 1.4% YoY. However, inflationary expectations have moved decisively higher: the 5-year TIPS/Treasury Breakeven rate has risen to 2.38% this week, from 1.95% at end-2020 and 2.18% on 1 February 2021.



Source: REAL-Economics.com, based on data from Trading Economics

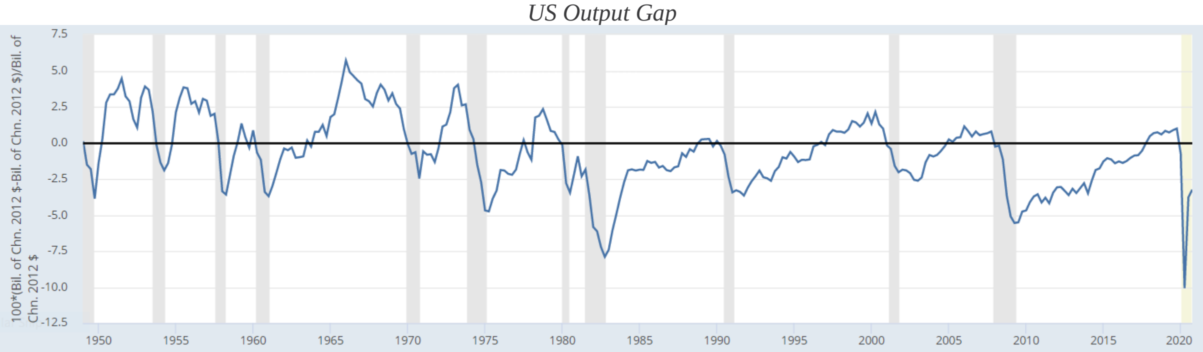
This quantum of monetary expansion cannot be sustained in 2Q 2021. The Fed added only a modest US$41 billion to its monetary base in January 2021 (much lower than the promised monthly purchase of US$120 billion of Treasury and agency securities). However, M2 growth accelerated slightly to 25.5% YoY, having settled into a plateau above 23% YoY since May 2020 (chart below, gold line), which appears to have become an unstated policy target. If inflation and inflationary expectations rise further, it will be impossible for the FOMC to sustain its commitment to purchasing US$120 billion of Treasury and agency securities every month -- and the decision to reduce those purchases will push yields higher still.



Source: REAL-Economics.com, based on data from FRB-St. Louis

The passage of Biden's US$1.9 trillion fiscal stimulus will take the fiscal deficit to a record 20% of GDP in FY2021. The US House of Representatives is close to passing President Biden's full US$1.9 trillion stimulus bill (including a minimum wage of US$15/hour to be progressively introduced over the next few years). The plan of passing this bill through a "reconciliation process" (joint meeting with the Senate) has run into a problem: the Senate's parliamentarian (non-partisan official) has ruled that a minimum wage increase cannot be part of a Budget reconciliation bill. Interestingly, this would make the bill palatable to wavering Democratic Senators (such as Joe Manchin of Virginia) and might even attract a few Republican votes in the Senate. Coming soon after the enactment of a US$ 900 billion stimulus at end-December, much of which will be spent in 1Q 2021, the further stimulus of US$1.9 trillion will push the fiscal deficit for FY2021 to a massive 22% of GDP, with about 2pp lopped off because of the stronger growth arising from the stimulus.

US Output Gap



Source: FRB-St. Louis

The US$900 billion stimulus (much of it coming through this quarter) will help close the output gap, making further QE superfluous. The output gap didn't close as much as expected in 4Q 2020 -- remaining at 3.2% of potential GDP, only slightly better than the previous quarter's 3.8%, which was a huge improvement on the output gap of 10% of potential GDP in 2Q 2020 (chart above). With the US$900 billion of stimulus in 1Q 2021, aggregate demand will get a major fillip -- as already evident in the strength of retail sales. The output gap should close to about 1% of potential GDP (with the unemployment rate also declining to below 6%). The seeming slack in the economy is unlikely to be entirely removed (because airlines, hotels and travel-related services will be slowest to recover, as will the commercial property market), but "full-employment" in a post-Covid economy is likely to be at around 5.5% unemployment. Once that level is reached by April 2021, actual core inflation is likely to edge toward 2% YoY. The FOMC will be obliged to reduce its QE in 2Q 2021, and to begin raising the Fed Funds rate by its July 2021 meeting.