The Big Bond Week

Quadrilemma crunch time, Mixed earnings thus far, Unfavorable GDP mix, QRA & FOMC belly ache, Vol market kind of complacent

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Crunch Time for the Quadrilemma

All eyes are on the FOMC meeting on Wednesday, but unless the Chair abandons their optionality and preannounces the start date for rate hikes or changes to balance sheet reduction 'running in the background', the more impactful policy event could be the Treasury's Quarterly Refunding Announcement (QRA). On Monday, Treasury will announce their revised estimate for 1Q24 financing needs as well as their first estimate for 2Q24. On Wednesday they will announce the specific maturities of their issuance plans.

The August QRA revealed an additional $500 billion of financing for 2H23, an announcement that kick-started nearly 3 months of bear steepening that culminated with 10-year USTs breaching 5% for the first time since the financial crisis. In October, the QRA was the first step in reversing the sharp move higher in longer maturity yields. The FOMC's policy put, a series of speeches acknowledging higher real rates were a substitute for additional rate hikes, followed by confirmation that the hiking cycle was complete (policy pause), combined with the Yellen Treasury shortening the duration of supply, stopped the bear steepening risk-off episode in its tracks. With $815 billion in the Treasury General Account (TGA), Treasury has the flexibility to maintain the current structure of bill issuance above the advisory committee (TBAC) recommended level. However, the bill issuance is draining liquidity from the Fed's RRP program and may force the FOMC to slow balance sheet reduction (QT), leaving them with a much larger balance sheet than pre-pandemic. With mark-to-market losses over $1 trillion and negative cash flow greater than $100 billion, the politics could prove toxic.

We are hopeful we do not have to sit through 45 minutes of reporters asking Chair Powell, phrased differently each time, about the timing of the first rate cut — in other words Einstein's definition of insanity. Instead, we hope they draw out some details of the QT discussion we expect to occur and where the Committee stands on Vice Chair for Supervision Barr's increasingly controversial capital proposal. Additionally, clarity on the mix of disinflation, growth relative to potential and labor slack required to begin reversing at least the last three excessive hikes would be useful, but the Chair is unlikely to provide this level of detail. By the end of the press conference, we expect investors focused on the timing and magnitude of rate cuts to be unsatisfied. Beware of investors claiming the timing or number of cuts doesn't matter, the 3m10y curve remains deeply inverted, and as such is a major challenge for all but the very largest banks. The household and portions of the nonfinancial corporate sector are increasingly reliant on expansive fiscal policy, for small banks and businesses credit is tight.

Friday's December employment report could restart the process of resolving the quadrilemma: a 4% policy rate that keeps the 10-year yield in the vicinity of 4% requires an unemployment rate above 4% and wage growth below 4%. We will release a more detailed employment preview next Wednesday, along with our initial thoughts on the FOMC meeting, but the big question for Friday is whether demand for labor or the supply of workers is easing faster. If participation recovers a portion of the sharp November decline and demand continues to weaken, a March cut could be back on the table.

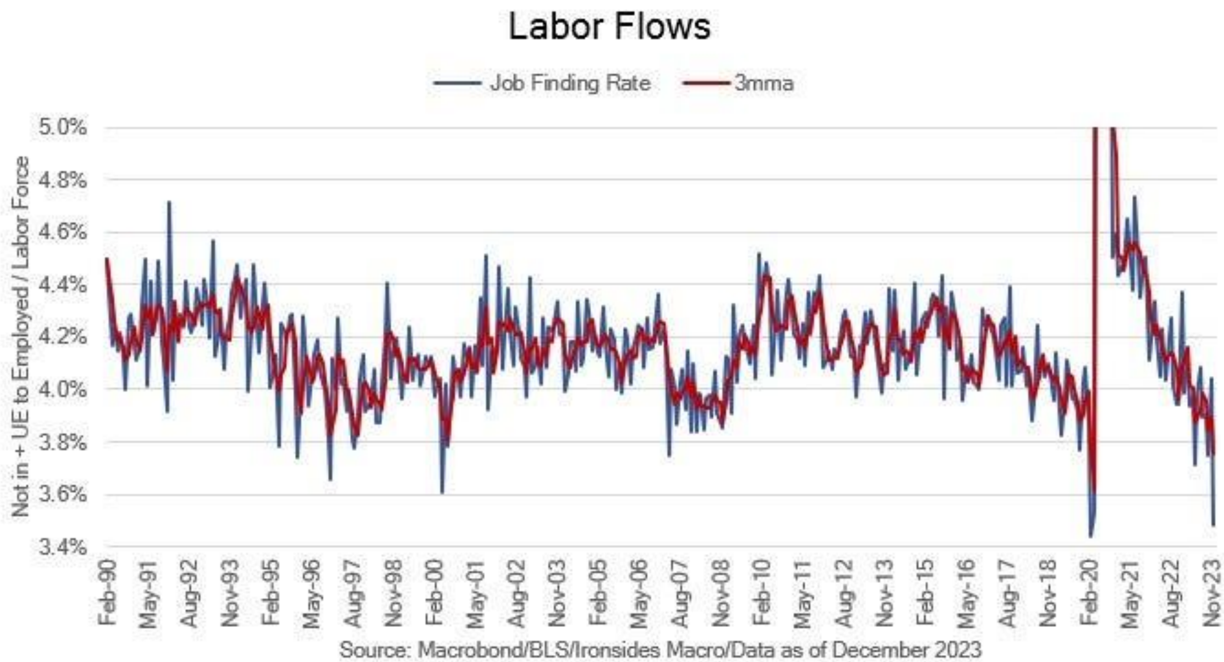

Figure 1: The job finding rate, flows from out of the labor force and unemployment to employment was the second lowest in the history of the flow data in December. This data, while volatile, has been trending lower implying demand for labor has weakened considerably, Unfortunately, the recovery in supply stalled in 2H23.

Muddled Macro Signal from Earnings

Treasury yields grinding higher due to increasing growth expectations tends not to trouble equity investors. This has been the case recently and was also the case in the early stages of the August- October bear steepening. It is only when the UST selloff intensifies that broad risk-off episodes develop. Meanwhile back in equity investorville, the generative artificial intelligence boom will be in focus with Microsoft, Google, and Advanced Micro Devices reporting on Tuesday and Meta and Amazon on Thursday. With 25% of S&P 500 constituents reporting thus far, earnings growth is tracking -1.6% on +3.7% revenue growth. Earnings surprise of 6.0% is modestly above the longer term ~4% trend, but it is below the prior 3 quarters. The average one-day reaction is unchanged; however, the S&P 500 is up 2.3% since the big banks kicked off earnings season two weeks ago, though the sector dispersion is large with the tech sector +7.6% and utilities -3.8%.

It looks to us like investors are still betting on an aggressive Fed cutting 'because they can' cycle; the KBW regional bank sector is flat on the year even as S&P bank earnings fell 11.6% and with 80% of Russell 2000 banks reporting, if Bloomberg's numbers are accurate, small bank earnings are running 34% below a year ago. The trend for net revisions is stable, our favorite leading indicator for the rate of change of earnings growth, however, revisions have turned higher for the economically sensitive consumer discretionary and industrial sectors, but only to neutral. Although it remains early in the process with a heavy financials weighting, 4Q23 results and 2024 guidance are not supportive of low double-digit earnings growth, but nor should they be viewed as smoking gun for slowing aggregate demand either. In other words, a muddled macro message.

Figure 2: The stabilization of net revisions in the consumer discretionary and industrial sectors is encouraging, but not yet convincing.

Growth is Good, But the Mix Matters

The 3.3% advanced guesstimate of 4Q23 GDP handily beat consensus of a 2% quarterly annualized increase. Consumption growth of 2.8% was marginally better than expectations of 2.5% led by a continued recovery in goods spending as we discussed in our review of the December retail sales report in last week's note, Fiscal Boom.

Investment, both residential (1.1%) and nonresidential fixed investment (1.9%), were weak, underscoring how excessively tight monetary policy doesn't just slow demand. In fact, due to large part to easy fiscal policy, demand hasn't weakened at all, but tight policy is damaging the supply side of the economy. Inventory investment was similar to 3Q23, consequently, it didn't contribute anything to GDP and is only 40bp above its longer run trendline. Government spending slowed from 5.8% to 3.3% but only because defense spending decelerated sharply from 8.4% to 0.9%, nondefense federal spending continued to hum along at 4.6% from 5.5% in 3Q, state and local spending was 3.7% vs 5.0%. Real final sales to private domestic purchasers, a measure of aggregate domestic demand, increased 2.6%, down slightly from 3% in 3Q23. Total compensation of employees, roughly 60% of gross domestic income, slowed from 5.5% to 4.5%. We will get our first look at gross domestic income in a month's time, given 4Q earnings tracking marginally negative and the slowing of nominal compensation, we expect GDI will be similar to 3Q's 1.5% real GDI and marginally softer than the 4.9% nominal increase.

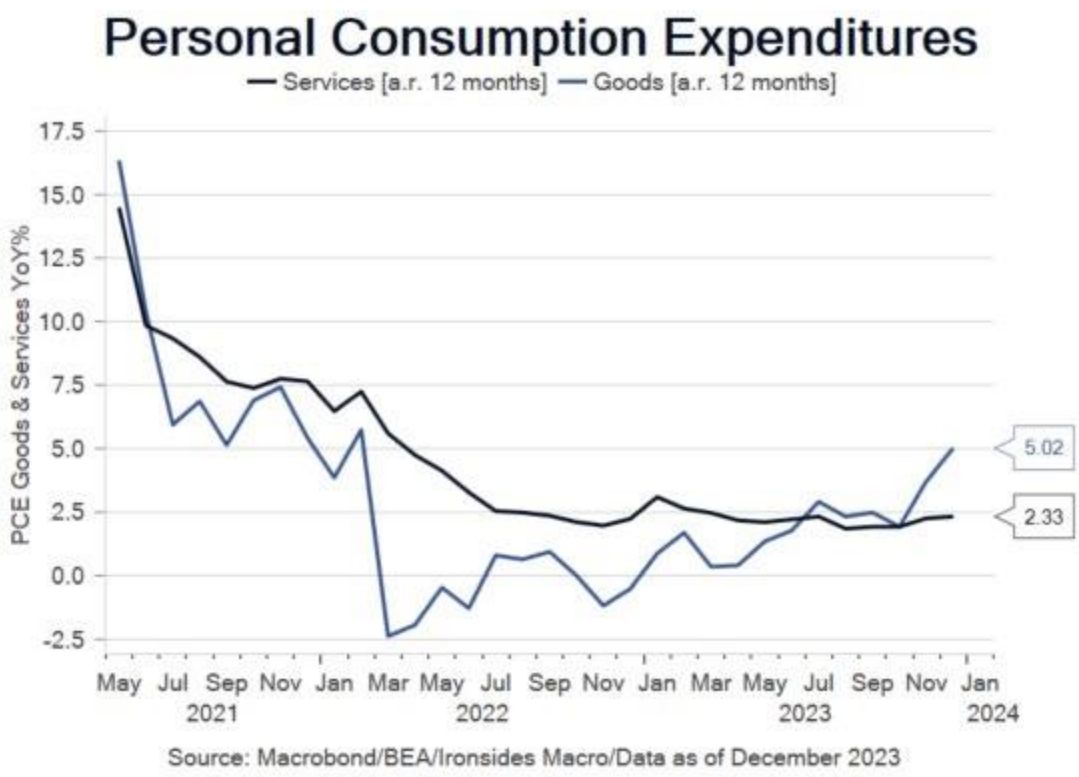

Figure 3: Goods spending is out pacing services hinting the post-lockdown recovery rebalancing has run its course.

The key reason for the ‘bottom line’ beat was a cooler than expected GDP deflator (core PCED was in-line at 2%), that meant nominal GDP slowed sharply from 8.3% to 4.8%. Friday’s personal consumption deflator showed core goods prices falling 0.27% in December and -3.3% quarterly annualized. In essence, the strength in real goods spending was flattered by price deflation. As was the case with CPI, the cooling of core PCED in 4Q23 was heavily dependent on goods deflation, PCED non-housing services is cooling faster than the CPI measure, however, housing services is running at a similarly hot level at 0.46% on the month, 6.38% from a year ago. The argument that rents have cooled is getting stale, most research points to a one-year lag but the Apartment List and Zillow Indices peaked 2 years ago, the new Cleveland Fed All Tenant measure peaked a year ago. We continue to expect housing services inflation to cool, but not back to pre-pandemic levels due to the damage monetary policy did to the supply side of the housing market.

Nominal GDP above 5% is roughly the rate (depending on mix) that offers sufficient aggregate demand for double digit earnings growth, 4% was the trend through much of the ‘10s when earnings growth trend was below 10%. The important takeaways from the advanced estimate of output are that fiscal spending is offsetting monetary restriction leading to decent trend consumption, but the mix is less favorable for private sector investment. Aggregate income growth (GDI) is running close to potential, nominal GDP is slowing, and the mix of expenditures is not as favorable as headline real GDP. The mix matters and the final quarter of ‘23 did not set the stage for a strong recovery in earnings; it could still happen, but we continue view yield curve disinversion that reopens the bank credit channel as crucial to a ‘healthy broadening out’. One final note, given the aggregate hours index from the December employment report was unchanged for the quarter, labor productivity (released Thursday) is set to have its third strong reading. With GDI running below GDP and it unclear how much of this residual is being driven by total factor productivity, it would be premature to conclude the ‘20s productivity boom we are expecting has begun. But faster labor productivity isn’t bad news, that’s for sure.

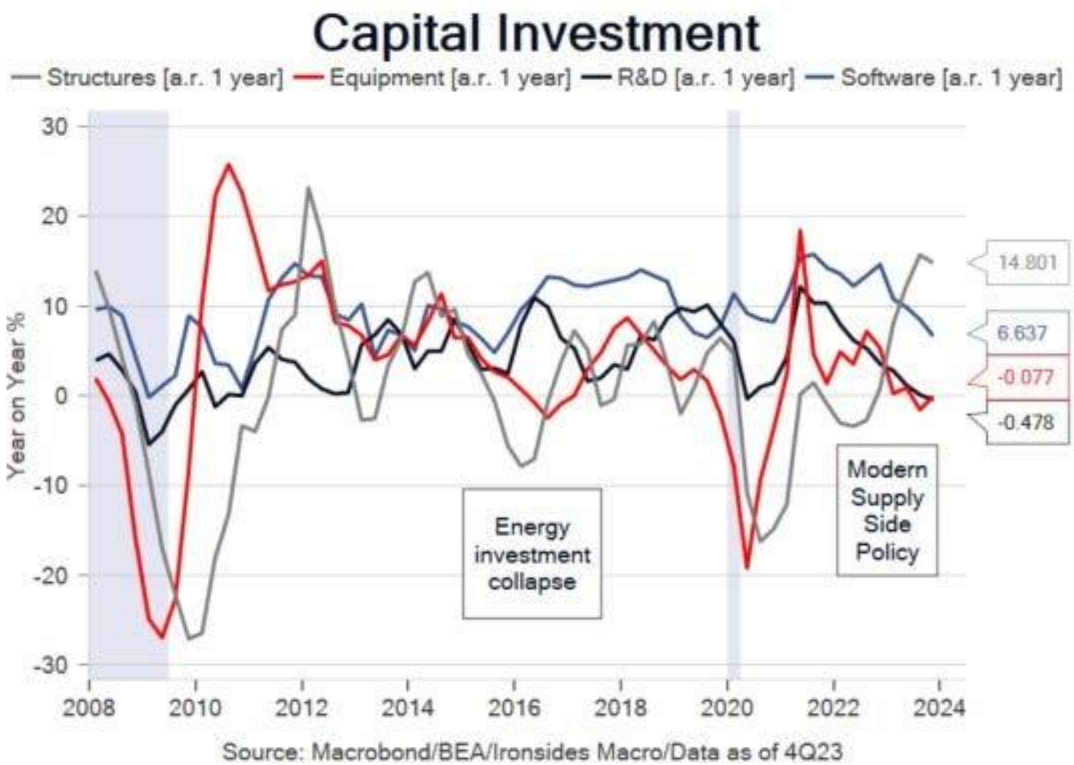

Figure 4: The only category that has been trending higher is structures investment due in large part to the three industrial policy bills, but even that category slowed in 4Q23. Equipment and R&D lost tax incentives at the end of 4Q22.

QRA & FOMC Preview: Belly Ache

We haven't seen any forecasts of the financing needs or potential changes to the issuance mix other than a few comments on 'FinX' (Finance Twitter) that it is likely to be a nonevent. Full disclosure, we spent time talking to the press about this issue. In October, Treasury expected to borrow $816 billion, since that report the monthly budget numbers exceeded deficit expectations by $88.5 billion. Consequently, an upside surprise is possible but not as large as the August $500 billion shocker. Recall the October QRA increased bill issuance above the Treasury Borrowing Advisory Committee 15-20% recommended range and slowed the rate of increase in longer maturity, instead increasing supply in the belly (2–5-year maturities). Treasury could decide to draw down their checking account at the Fed and leave the current approach intact, however, with bills yielding more than the Fed's reverse repo program (RRP) and the Fed's next move likely to be a cut, government money market funds with $4.9 trillion of assets, up $865 billion since Silicon Valley Bank collapsed, are likely continue the rapid RRP liquidity drain (buying bills rather than depositing cash at the Fed). The FOMC is likely to debate the implications Tuesday and Wednesday, former SOMA manager and current Dallas Fed President Logan views the drop in RRP as a reason to slow QT, NY Fed President Williams in a follow-up speech stated he thought reserves were well above the lowest comfortable level and there was no modification of QT in sight. We side with Logan on this, we reviewed the special questions from the Senior Loan Officer Survey in May shortly after the Silicon Valley collapse, but prior to the Administration's banking regulatory appointments capital proposal. At that time 75% of respondents had a policy of the lowest comfortable level as a 'hard floor', and 35% targeting 50% above that level. Estimates at that time for the system from the most informed analysts including our former colleague Joe Abate at Barclays were ~$2.7 trillion, but since that time banks raised their cash assets sharply and several large regional bank CEOs and industry analysts continue to discuss building capital and liquidity.

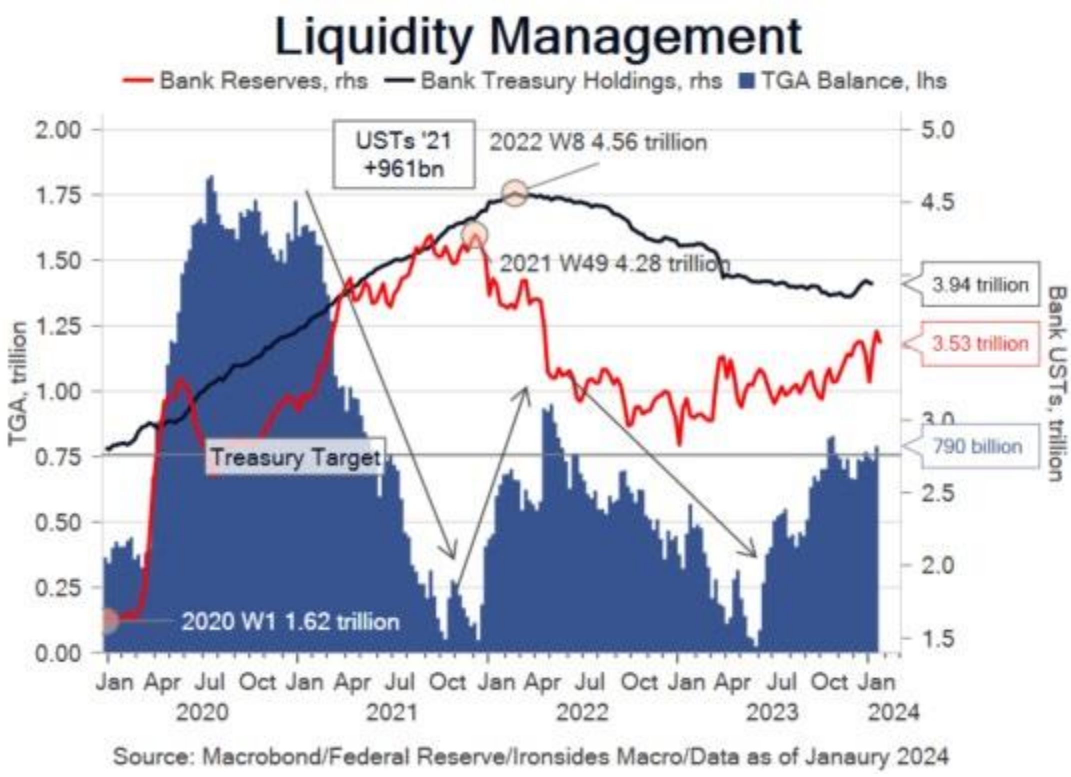

Figure 5: The TGA near target offers some flexibility, the Fed's balance sheet might be the limiting factor that forces Treasury to extend the duration of issuance.

Treasury liquidity and duration management under Secretary Yellen, due in large part to the largest fiscal impulse since WWII and nondefense stimulus in US history, has been arguably more impactful on capital markets than the actions of the Federal Reserve. The draining of TGA by reducing issuance from February through September '21 injected more liquidity ($1.6 trillion) than the Fed did in the entire year. The rebuild to $900 billion from $50 billion from January through April '22 kicked off the 10-month correction in equities. Liquidity was abundant in '23 due to the debt ceiling restricting issuance and the Fed's passive QT program until the Fiscal Responsibility Act. After a suspension of the debt ceiling, Treasury rebuilt TGA through bill issuance, when they attempted to extend issuance duration in 3Q23 as some participants like Stan Druckenmiller suggested they should, additional longer duration issuance triggered a sharp increase in longer maturity rates. Given the political sensitivity of the debt, they may decide to roll the dice on r*, in other words the Fed's longer run forecast of a 2.5% policy rate. However, with a deeply inverted curve, heavy front-end issuance is increasing interest expense rapidly, and risks forcing the Fed to prematurely slow and end QT. While equity market participants' first reaction would be to cheer the end of QT, they shouldn't, due to the distortion of the capital allocation process. 10-year real rates are below the '00s average rate and term premium is negative, the responsible policy action is to issue further out on the curve. We understand the political incentive to keep mortgage rates low, but this is a risk Treasury should be taking on behalf of taxpayers. On balance, the risks are skewed towards an increase in the weighted average duration of issuance that is likely to put upward pressure on rates. Wednesday's weak demand for $61 billion of 5-year notes offered a preview of what additional coupon supply is likely to do for Treasuries, and risk assets broadly.

Figure 6: The part of the curve least influenced by Fed rate or balance sheet policy, and most influenced by the supply of Treasury duration, 30-year real rates, are grinding back higher after the late '23 rally.

Please Fed Reporters, Don't Spend the Entire Presser on the First Cut

If the Fed reporters spend the entire press conference asking about the timing of the first rate cut without forcing the Chair to provide specificity around their reaction function, ideally in the form of some version of our quadrilemma framework for example, it'll be a colossal waste of time. We would like to hear about QT, bank capital, the dependency on goods deflation to the disinflationary trend, the role of fiscal expansion to inflation, the supply of labor setback in recent months and whether the Committee continues to believe that the longer run policy rate is 2.5%. Alas, we suspect we will be left unsatisfied waiting for speeches from Logan on QT, Goolsbee on goods inflation, the battle of Bowman and Barr on bank capital and Waller on the labor market.

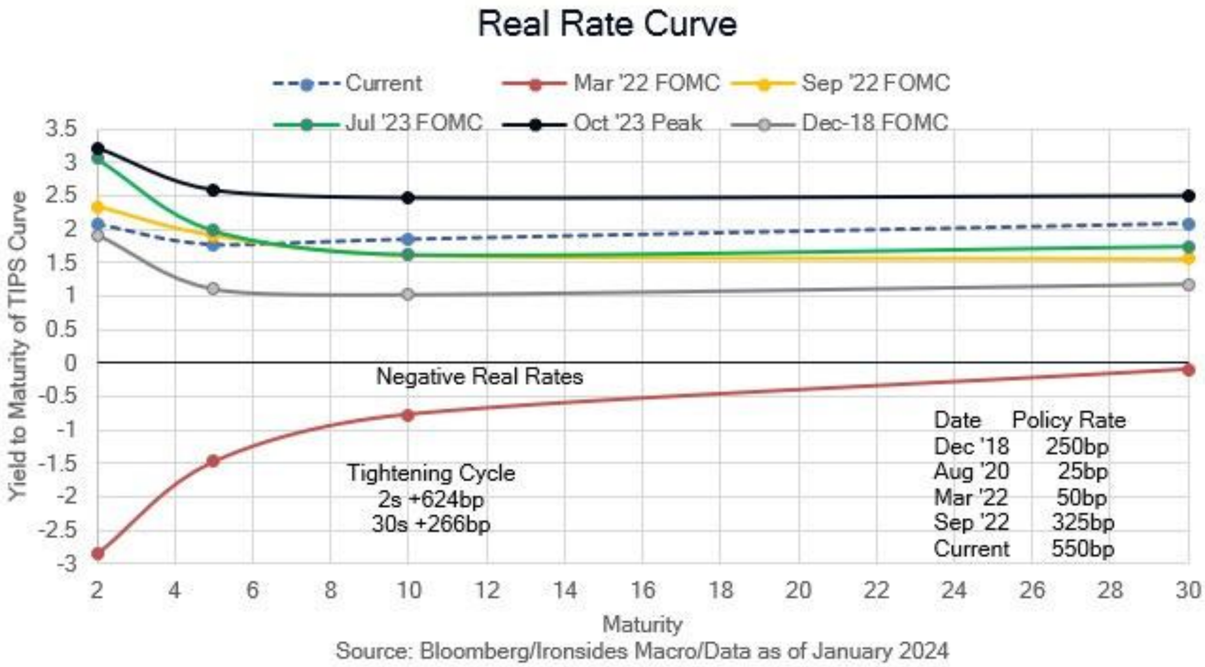

Figure 7: The real rate curve is flattening and is at the same level as the end of the 2018 cycle. The longer end is below the 2018 terminal level, in our view the Fed 'mid-cycle' easing was only necessary due to non-monetary policy tightening. The Tax Cuts & Jobs Act increase in the standard deduction and state & local tax deduction limit caused a one-year correction in the housing market, similar to the 1986 tax reform. Additionally, the US/China trade war sent global manufacturing and trade into a recession. We suspect r is higher than the FOMC thinks.*

Final Thoughts

The structure of the market for equity index volatility on the surface appears complacent; the Volatility of Volatility of Volatility Indices are .5 and .7 of a standard deviation (SD) below their longer-run median levels. Implied correlation is nearly 2 SDs below its median, hinting investors are a long way from defensively 'hugging' the index. However, the premium for out-of-the money options and correlation of upside calls relative to downside puts (melt-up risk) are both elevated, implying there are some hedgers lurking in the shadows. Short-term Treasury implied volatility looks modestly elevated though as we have discussed, we think QE volatility suppression that reduced the median level by 25% (100bp to 75bp) during the '10s is over. FX implied volatility is quite low, we suspect diverging economic and inflation outlooks will increase realized exchange rate volatility through 2024.

Measures of Risk	Median	Standard Deviation	Max	Min	Current	Z-score	Implied Risk
S&P 500 Volatility Index (VIX)	17.62	8.14	82.69	9.14	13.33	-0.53	Below Average
S&P 500 Vol of Vol Index (VVIX)	91.66	16.29	207.59	61.76	80.27	-0.70	Below Average
S&P 500 Term Structure (6m-1m)	3.00	4.23	10.85	-40.45	2.91	0.02	Average
S&P 500 Skew Index	119.78	9.72	170.55	104.09	153.05	3.42	High
S&P Implied Correlation	44.51	14.39	90.79	15.87	17.71	-1.86	Low
Call Corr - Put Corr Meltup Risk	-34.25	11.24	10.05	-99.80	-21.07	1.17	High
Treasury Vol (MOVE)	89.41	29.36	264.60	36.62	105.89	0.56	Above Average
FX Vol (JPMVXYGL)	9.77	2.43	27.02	5.18	7.51	-0.93	Below Average
BB&D Policy Uncertainty	84.04	77.89	807.66	3.32	110.29	0.34	Average
Lehman Corporate OAS	1.20	0.77	6.18	0.51	0.93	-0.35	Average
Lehman High Yield OAS	4.26	2.40	19.71	2.33	3.34	-0.38	Average
EEM Volatility Index	20.85	6.51	92.46	13.11	17.18	-0.56	Below Average
Median Across Asset Classes						**0.02**	**Average**

Source: Bloomberg/Ironsides Macro/Data as of January 26. 2024

Figure 8: Our measures of risk are near the longer-run average, however, there is considerable dispersion within and between asset classes.

We are excited for next week. The QRA, FOMC meeting, labor market data and big tech earnings should go some distance towards providing clarity as to the likely winner of the dynamic private sector productivity boom, or overly interventionist potential policy bust. For the year we remain convinced the dynamic private sector will overcome misguided policy, but we remain cautious in the near term.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Z-score	Ironsides Strategic Weighting	ERP	ERP Z-Score
SPX	24.05	20.75	2.66	4.60	2.93	15.15	1.46	Underweight	2.51%	1.62
SPW (equal weight)	16.09	15.77	0.02	2.90	1.98	11.17	0.30	Underweight	3.54%	1.86
Discretionary	29.12	23.98	2.22	9.16	2.48	15.98	1.62	Market	2.03%	1.17
Financials	17.01	15.06	2.33	2.09	2.37	#N/A N/A	0.32	Underweight	4.31%	1.25
Technology	38.31	30.77	8.19	11.90	8.29	26.31	2.28	Market	0.98%	1.47
Comm Services	22.84	18.60	3.56	4.20	3.95	14.25	1.60	Market	2.77%	1.85
Industrials	23.14	19.96	2.17	5.59	2.59	16.49	1.54	Overweight	2.59%	1.39
Materials	19.31	18.94	1.98	2.87	2.35	12.31	0.93	Overweight	3.24%	0.87
Energy	10.33	11.54	1.19	2.15	1.36	6.12	0.05	Overweight	7.28%	-0.45
Healthcare	23.47	18.44	1.73	4.86	1.88	16.77	0.28	Overweight	2.62%	1.38
Staples	20.72	19.88	1.38	5.82	1.60	16.02	0.66	Underweight	3.07%	1.18
Utilities	16.98	15.39	2.09	1.83	3.98	12.33	0.88	Underweight	4.17%	1.14
Real Estate	41.85	35.86	6.47	6.47	8.96	20.42	-0.70	Underweight	0.81%	1.22
Russell 2000	34.25	24.10	1.22	2.04	36.95	1.70	0.22	Underweight	1.31%	1.23

Source: Bloomberg/Ironsides Macro/Data as of January 2024

Figure 9: Tech and the market are vulnerable to disappointment next week given the magnitude of outperformance and the narrow nature of the rally.

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