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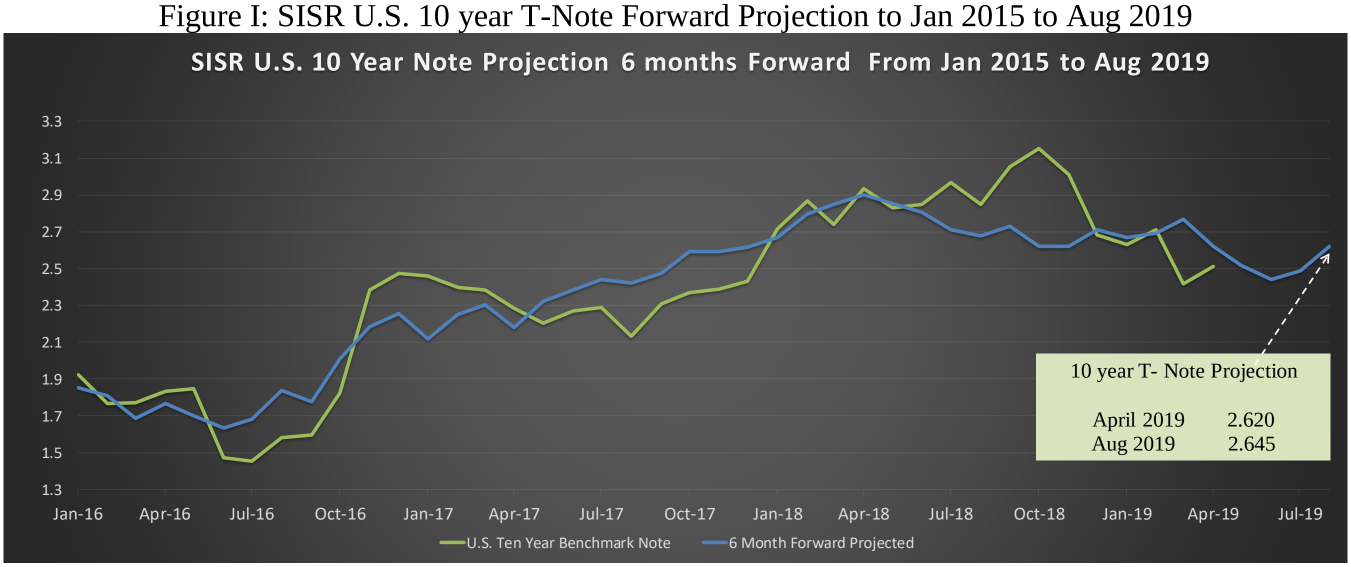
U.S. 10 year T-Note Yield likely to appreciate to 2.6%- 2.8% through mid year – Model however cannot anticipate future data _Theory tells a different Story

Figure I: SISR U.S. 10 year T-Note Forward Projection to Jan 2015 to Aug 2019



Source, SISR proprietary Model

Introduction

The equity markets have almost fully recovered the recent correction, however the bond market has not with the current yield on the 10 year note at 2.518%. The SISR 10-year bond model has a forward projection of the 10-year government benchmark projecting 2.62 by the end of this month and being essentially flat through August 2019 ending in August with a yield of 2.645 based on the current data. The problem with this projection is that it cannot anticipate future changes in M2 growth. As shown previously the Fed during their late March meeting altered their balance sheet drawdown policy.

On March 21,2019 the Federal reserve modified its Balance Sheet Normalization Principles with the following statement:

> *The Committee intends to slow the reduction of its holdings of Treasury securities by reducing the cap on monthly redemptions from the current level of $30 billion to $15 billion beginning in May 2019.*

- *The Committee intends to conclude the reduction of its aggregate securities holdings in the System Open Market Account (SOMA) at the end of September 2019.*
- *The Committee intends to continue to allow its holdings of agency debt and agency mortgage-backed securities (MBS) to decline, consistent with the aim of holding primarily Treasury securities in the longer run.*
    - *Beginning in October 2019, principal payments received from agency debt and agency MBS will be reinvested in Treasury securities subject to a maximum amount of $20 billion per month; any principal payments in excess of that maximum will continue to be reinvested in agency MBS.*
    - *Principal payments from agency debt and agency MBS below the $20 billion maximum will initially be invested in Treasury securities across a range of maturities to roughly match the maturity composition of Treasury securities outstanding; the Committee will revisit this reinvestment plan in connection with its deliberations regarding the longer-run composition of the SOMA portfolio.*
    - *It continues to be the Committee's view that limited sales of agency MBS might be warranted in the longer run to reduce or eliminate residual holdings. The timing and pace of any sales would be communicated to the public well in advance.*

Over the past few weeks we have shown that the 10-year T-Note is driven mostly by

1. Economic growth and
2. Inflation expectations

Whereas the 2 year and 3-month T-Notes are driven almost exclusively by:

1. Fed Fund expectations

We have argued over the past couple of months that: With the economy at full employment evidenced by there being more job opening than individuals unemployed. This fact alone should cause top line inflation, if not only wage inflation. However, with wages still near 40-year lows and with both U.S. and global excess capacity, there is INSUFFICENT demand to cause inflation. Having the economy at full employment is a necessary and sufficient condition for there to be inflation, that is not caused by an economic shock, like a significant spike in the price of oil or other commodity prices. The problem is that with:

1. wages only recently rising only slightly from a 40-year low, consumer spending has slowed from a 6% annual rate of growth to the current 2.5% rate of growth,
2. the contribution to GDP from government spending has declined from over 0.6% to negative slowing another major component of growth i.e. government demand.

3. With these two critical components of the GDP equation declining, it is not surprising that the third major component of GDP, investment has also slowed. There is no reason to invest in plant and equipment, unless there is increased demand for products.
4. Then combine this with U. S. excess capacity, in conjunction with global excess capacity.

The net effect is that U.S. growth will be stuck in the 2% range until there is more product demand. Global Tax policy has not helped this situation, by reducing corporate and taxes on high-income families while ignoring the middle class, consumer demand is going to continue to show lower and lower growth rates. Many in the middle class, who are the primary consumers, live paycheck to paycheck, so if they had more money, they likely would spend it.

This slow growth argument should keep the 10 year in check as the model is showing, with the model showing. That the Ten-year T-Note should remain in this 2.5 to 2.6 range through the end of summer. The model as all models is based on the current economic data, projecting forward because of the leading indicators build into the model.

What Theory Tells US

If we extend the slow growth argument to include money supply which will expand during the Fed latest reiteration of their balance sheet normalization policy. With the inclusion of money into the discussion, the obvious implication is that if M2 increases rapidly cause by the unchecked decline in excess reserves, higher inflation should follow. When tied to the slow growth argument, the likely outcome is slow growth with higher inflation.

Full employment is the necessary condition for inflation, but higher M2 growth generally assumes that some of the increased growth is coming from the greater amount of lending which in turn is creating more productive activity. However, with excess capacity this likely will not occur. With the Fed stopping QT as Excess Reserves continues to decline, in conjunction with slow economic growth, and greater M2 expansion, this is the recipe for Stagflation. With full employment, and slow growth, and higher M2 growth there likely will be Stagflation, defined as higher inflation with slow growth.

Implications

If M2 expands as we expect with the slowing of the rate of Fed drawdowns, then we should expect some inflation. If inflation is higher than currently expected fueled by M2 growth, and if theory hold true to form, the current model should be underestimating expected inflation, which should lead to a higher Ten-year T-Note by year end of perhaps 3+% or higher.

Additionally, if Theory hold True to form, the 2-year should remain tied to Fed Fund expectations, or more directly Federal Reserve interest rate policy. This should mean in Theory that the yield curve should expand out.
Finally, this would have major implications for the expectation of a possible recession. It would push out a possible recession back to when the Fed starts to raise interest rates in response to possible inflation.

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