SPECTRA MARKETS

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am FX

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Current Views

Short CADJPY 101.21
Stop 102.61
Take profit 97.11

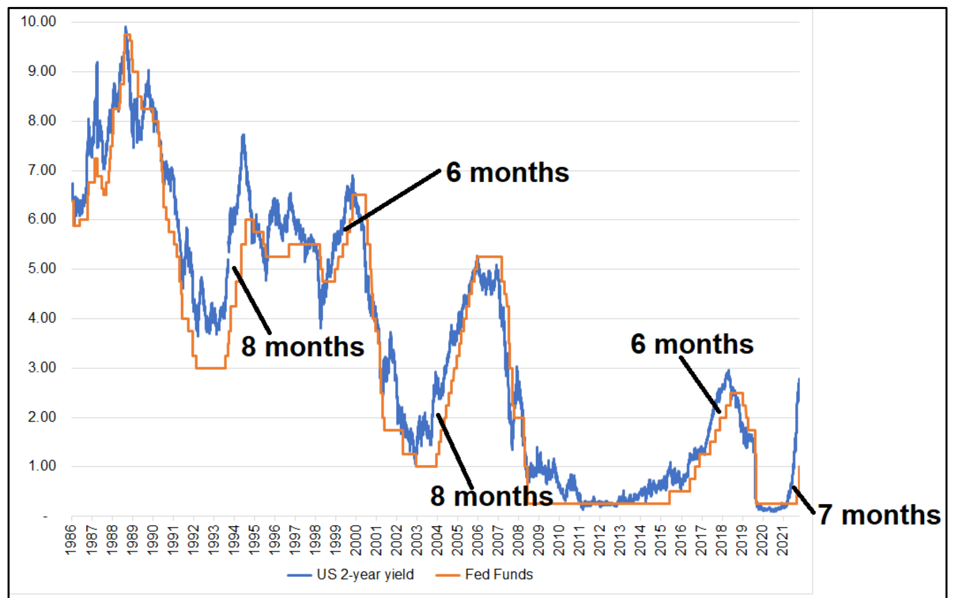
Forget UR, short CADJPY

Some Fed speakers were out doing damage control over the weekend as they attempt to explain or excuse accusations that the Fed's behind the curve. Christopher Waller's speech concludes with:

> In a world of forward guidance, one simply cannot look at the policy rate to judge the stance of policy. Even though we did not actually move the policy rate in 2021, we used forward guidance to start raising market rates starting with the September 2021 statement, which indicated tapering was coming soon. The 2-year Treasury yield, which I view as a good market indicator of our policy stance, went from approximately 25 basis points in late September 2021 to 75 basis points by late December. That is the equivalent, in my mind, of two 25 basis point policy rate hikes for impacting the financial markets. When looked at this way, how far behind the curve could we have possibly been if, using forward guidance, one views rate hikes effectively beginning in September 2021?

This seems like a stretch to me. The chart below shows the lag between the moves in 2-year yields and Fed Funds. In hiking cycles, that lag has been stable around 6-8 months since the 1990s. So either a) forward guidance doesn't change anything or b) forward guidance kind of existed for much longer than people remember. This paper from the Fed argues the latter. Forward guidance has become much more well-known now but was used on occasion even in 1974 and 1982.

US 2-year yields tend to lead Fed Funds by 6-8 months during tightening cycles



So the idea that rate hikes began in September 2021 purely because of Fed guidance is a stretch. Two-year yields lifted off because the data clearly showed "transitory" was wrong around September 2021 and the market took the ball and ran with it. The Fed dropped transitory in November, well after the market discarded it.

Bullard's speech offered a similar explanation that almost makes it sound like the real Fed policy tool is the US 2-year yield. This is similar but different to Kashkari's argument that it isn't the Fed Funds target rate that matters, it's 30-year mortgage rates. Here's the key slide from Bullard:

- In light of the forward guidance that has been given by the Fed since the fourth quarter of 2021, the 2-year Treasury yield may provide a better representation of where Fed policy is likely to be in the near future.
- The value of the 2-year Treasury yield as of May 5 was 2.71%, about 90 basis points shy of the rate recommended in the simple Taylor-type rule calculation.
- This suggests the Fed is not as far "behind the curve," although it would still have to raise the policy rate to ratify the forward guidance.

This is all incredibly circular, of course, as Fed commentary and the US data combine in complex ways to formulate rate expectations. But I would argue the data and the market triggered the pivot, not the Fed or its forward guidance. The credibility of the guidance was near all-time lows entering Q4 2021 as the Fed was clinging to the transitory script while the market was loudly calling BS. Then, the Fed followed the market. Also, I think it's a bit disingenuous for Fed governors to now point to 2-year yields or 30-year mortgage rates as the Fed's policy tool. The tool is the Fed Funds rate and they could have raised it in late 2021. Instead, they were in the market buying assets for no reason other than lazy inertia.

Now, the market is trying to push the Fed harder and price more than 50bps for June and the Fed is desperately trying to regain control of pricing after handing it to the market for the past six months. My guess is that **they will succeed** because there are many headwinds facing the US economy now, even as the jobs data prints strong.

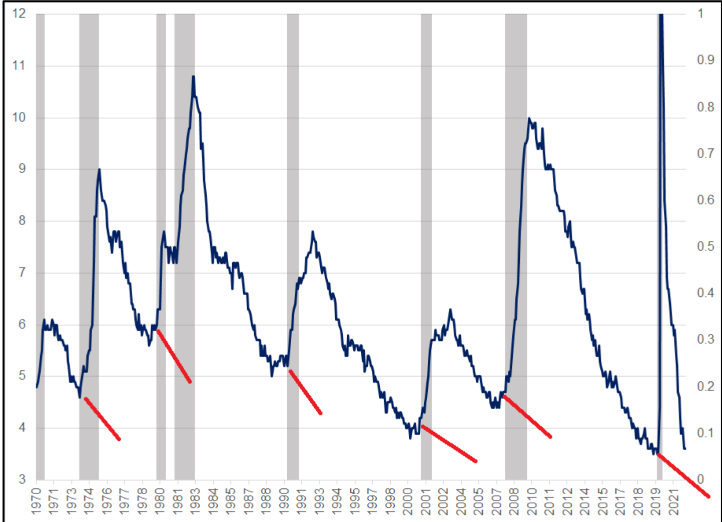
But the jobs!

While it looks like the Chinese and European economies are in trouble, the US continues to chug ahead and supporters of the US economic story point to the robust jobs market to and question slowdown logic. This is surprising to me because the US jobs data is notoriously lagging. Current strong jobs are **not** a strong argument against imminent economic weakness. While housing and hospitality are still suffering from job shortages, the parade of anecdotes out of tech remind me of 2000/2001.

In 2001, you had a clear domino effect. First, stocks dumped, then hiring slowed, then layoffs began.

Before we look at the current cycle, a few reminders of how the jobs market lags.

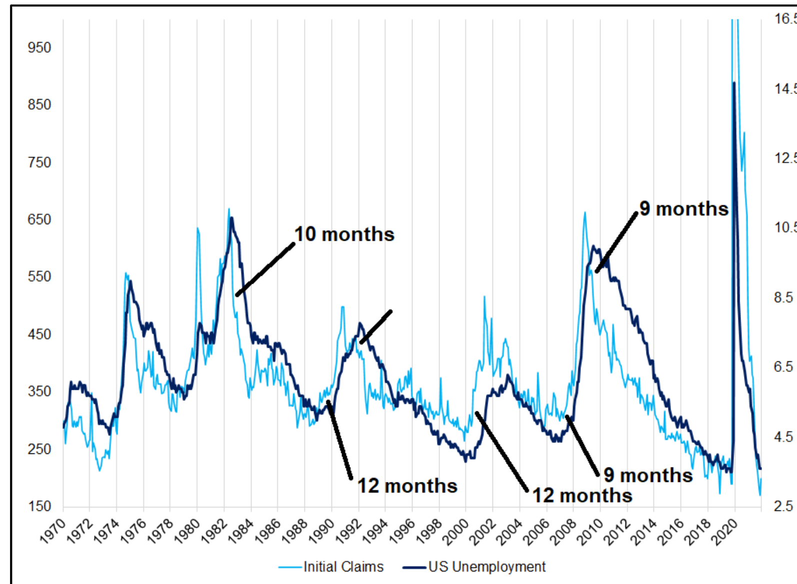
US unemployment rate is always at the lows when recession begins



Blue line = US UR, gray bars = US recession

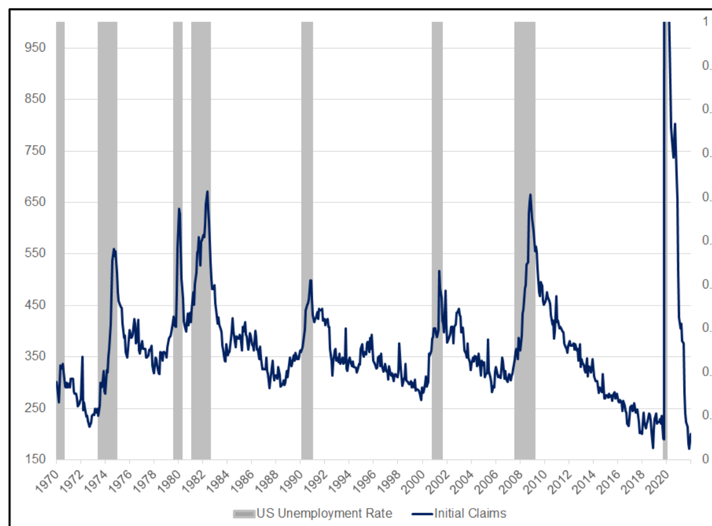
Why does the UR lag? Two reasons. 1) Because employment is generally a lagging indicator. Confidence and spending fall way before unemployment starts to rise because employment is sticky and employers don't just fire workers at the first sign of weakness. 2) The unemployment rate specifically is super laggy, even relative to other employment indicators. Here's the unemployment rate vs. Initial Claims.

US Unemployment is just a lagged version of Initial Claims



The US Unemployment rate is completely useless as an economic indicator. I truly don't know why anyone even looks at it. It lags the cycle massively. Even Initial Claims, which moves way head of the UR, don't give you much heads up for a slowdown as most of the job losses happen during the recession, not before.

US Initial Claims vs. US recessions

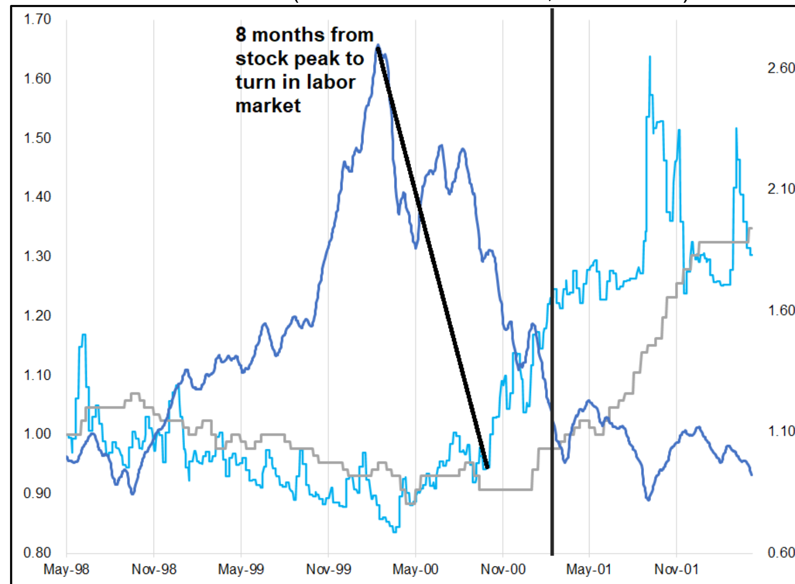


My main point today is that a strong jobs market is not an argument against imminent US economic weakness. On the contrary, every period of major economic weakness in the United States in my lifetime started with US unemployment at multi-year lows and strong US jobs data.

If your eyes are good, you might have noticed in the previous chart that Initial Claims did give a decent signal in 2000. Here is how the cycle played out that time:

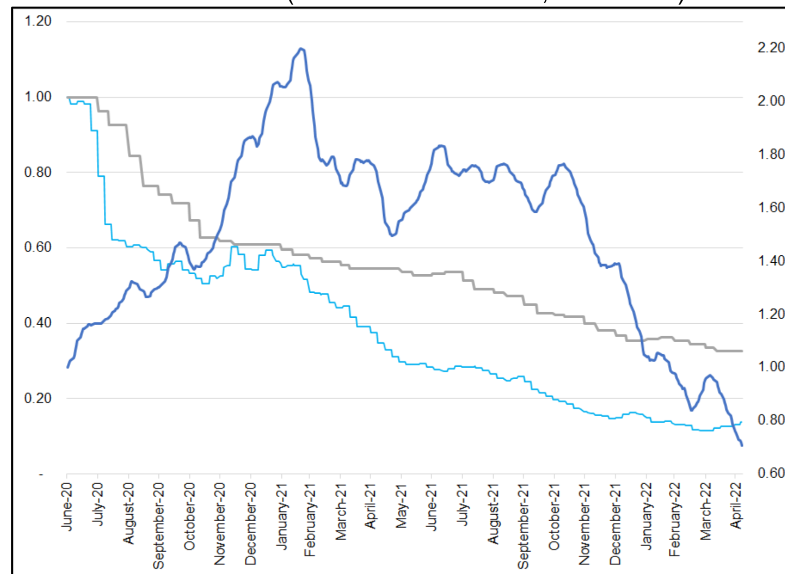
The dark blue line is the NASDAQ, light blue is Initial Claims and gray is the Unemployment Rate. You can see stocks peaked and crapped out through 2000, but the jobs market held in for ages. Then, in late 2000, Claims started ticking up. Recession started in March 2001 and the Unemployment Rate moved higher in mid-2001. The only clue you got from the UR was the flatline and tiny tick higher in JAN/FEB 2001[1]. The series are all rebased to 1.00 as of June 1, 1998 so that they can be compared and overlayed.

NASDAQ, Initial Claims, and US Unemployment
1998 to 2002 (normalized to June 1, 1998 level)



Here's the same configuration now, using ARKK instead of NASDAQ as that ETF represents the hopes and dreams for the new, new economy in the WFH bubble the way NASDAQ did in 2000. It has been 14 months since ARKK peaked in February 2021.

NASDAQ, Initial Claims, and US Unemployment
1998 to 2002 (normalized to June 1, 1998 level)



[1] Not enough to trigger the Sahm rule at that point, though.

It is fiendishly difficult to determine where we are in the economic cycle and that is part of why forecasting the economy is pretty much impossible. At cycle turns, it's not even clear where we are, let alone where we are going. My view is that we could be very close to a cycle turn here as two of three global growth engines have stalled (Europe and China), tech is done hiring as VC dries up following equity market weakness, fiscal drag starts for real now as consumers have spent all their stimmies and are squeezed by high gas prices.

If you were ever going to take a shot long bonds, this is probably the place to do so. If 10s break 3.33% or 2s break 3.03%, I'm completely wrong on fixed income and I will give up on the idea. Until then, the evidence to me suggests we are at peak global reflation and peak global interest rates.

If I am correct, long TY, short NZDJPY, short CADJPY are the best ways to play it. I am going short CADJPY here (101.21). Target 97.20. If global rates pull back, CAD should suffer and there is a nice triangle in CADJPY here that makes the risk management decision pretty easy. Stop loss on the clear break of the triangle, 102.61. As always, see sidebar on page 1 for trade details.

Closing thoughts

There were many probes below BTC 30,000 in 2021, but it never closed below 30k.

Hope you sock it to the market today.

good luck ⇅ be nimble

The first socks appeared in Ancient Greece, around 800 BC. They were designed to be worn with sandals. We have come full circle.

Oldest known pair of socks
https://collections.vam.ac.uk/item/O107787/pair-of-socks-unknown/

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