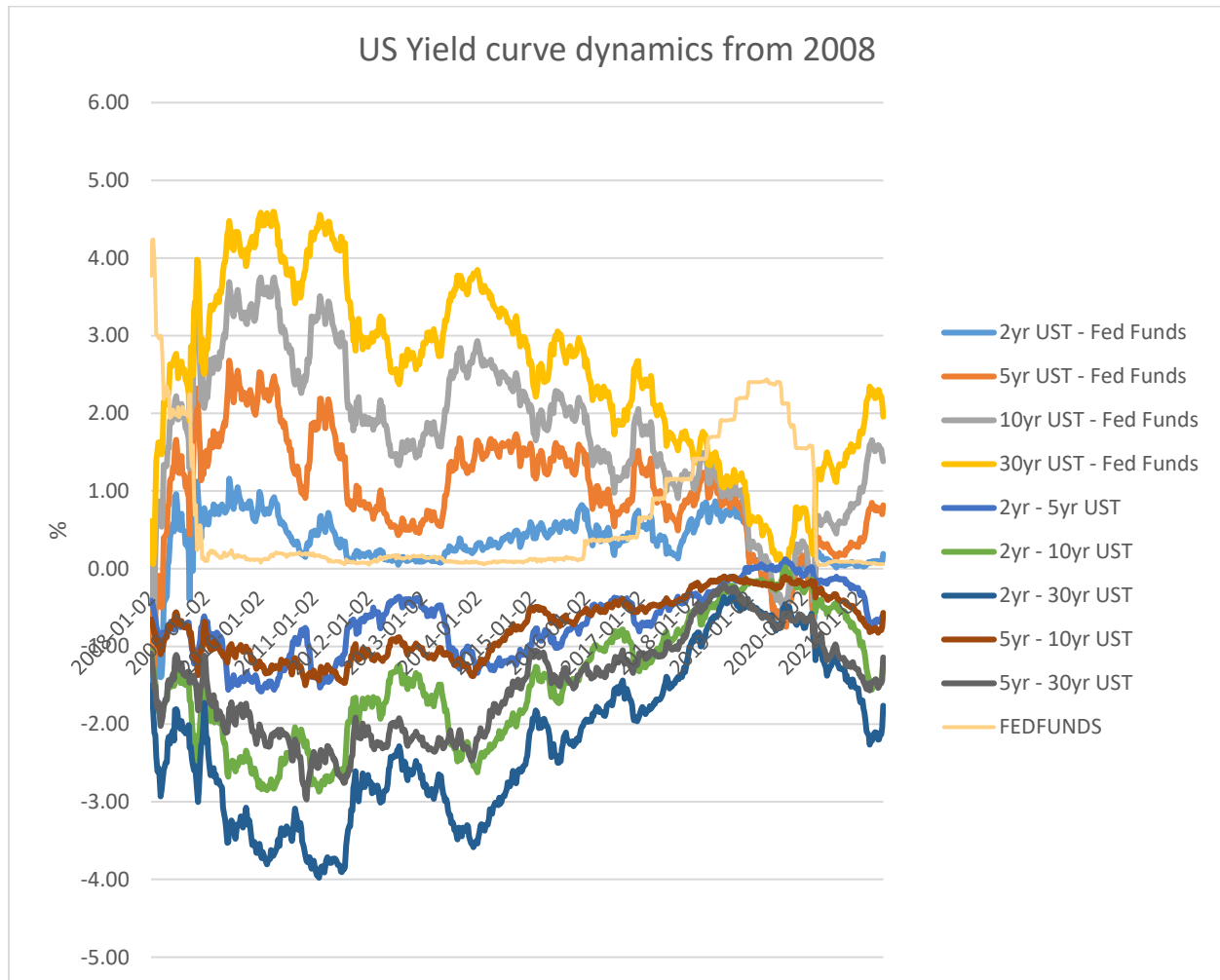


Why the US yield curve could continue to flatten from here

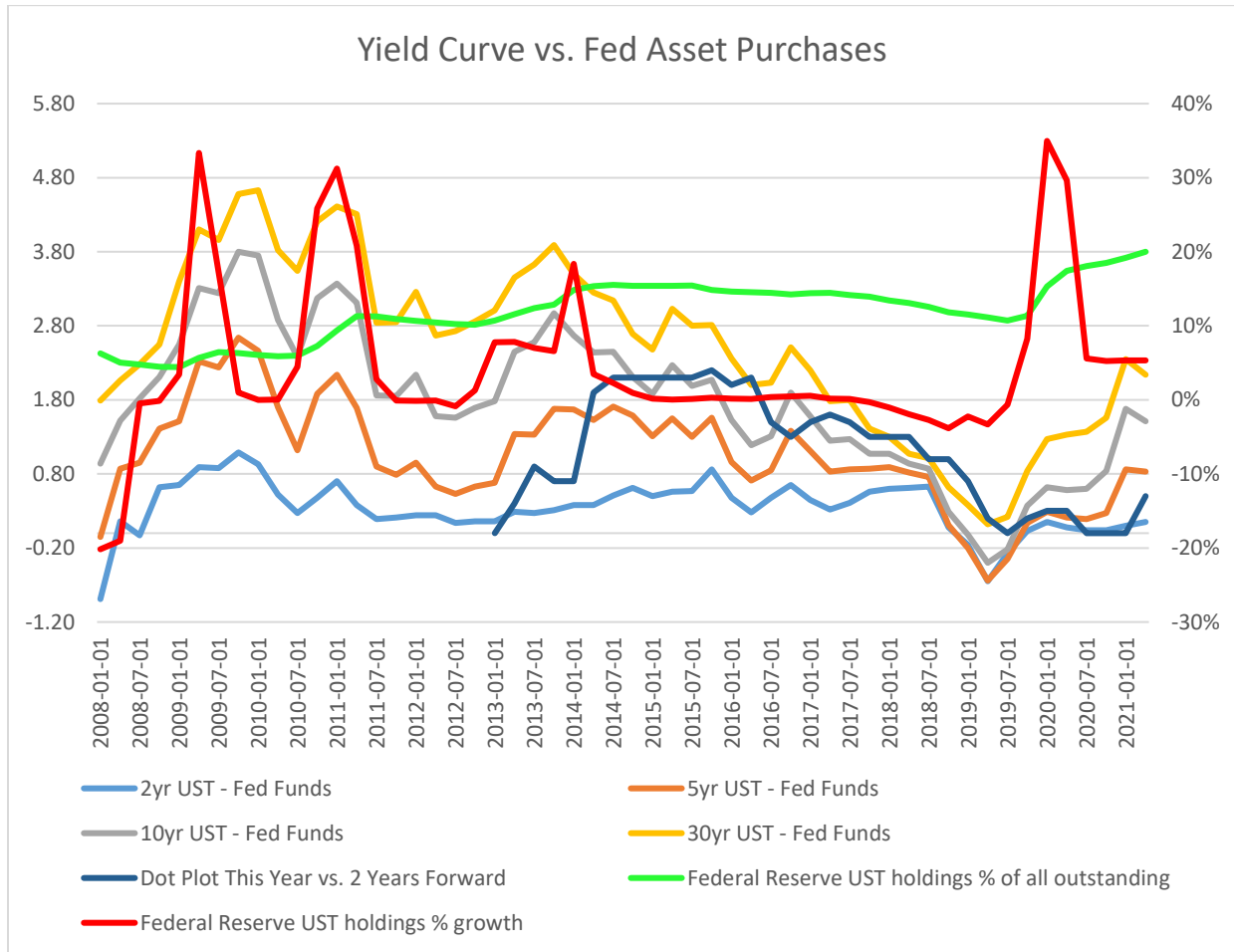


Source: FOMC, FRED St. Louis

The June 2021 FOMC meeting caused quite a bit of disruptions in markets with 30yr yields dropping 20bps over the week after the dot plot moved up by 50bps for 2023. The yield curve flattened quickly within 2 days with 2yr moving higher, 5yr roughly flat and 10yr and 30yr moving lower (in yield terms). Since the introduction of Quantitative Easing there hasn't been any period that resembles the current one – however, it is looking the most similar to 2013; just when the dot plot was invented.

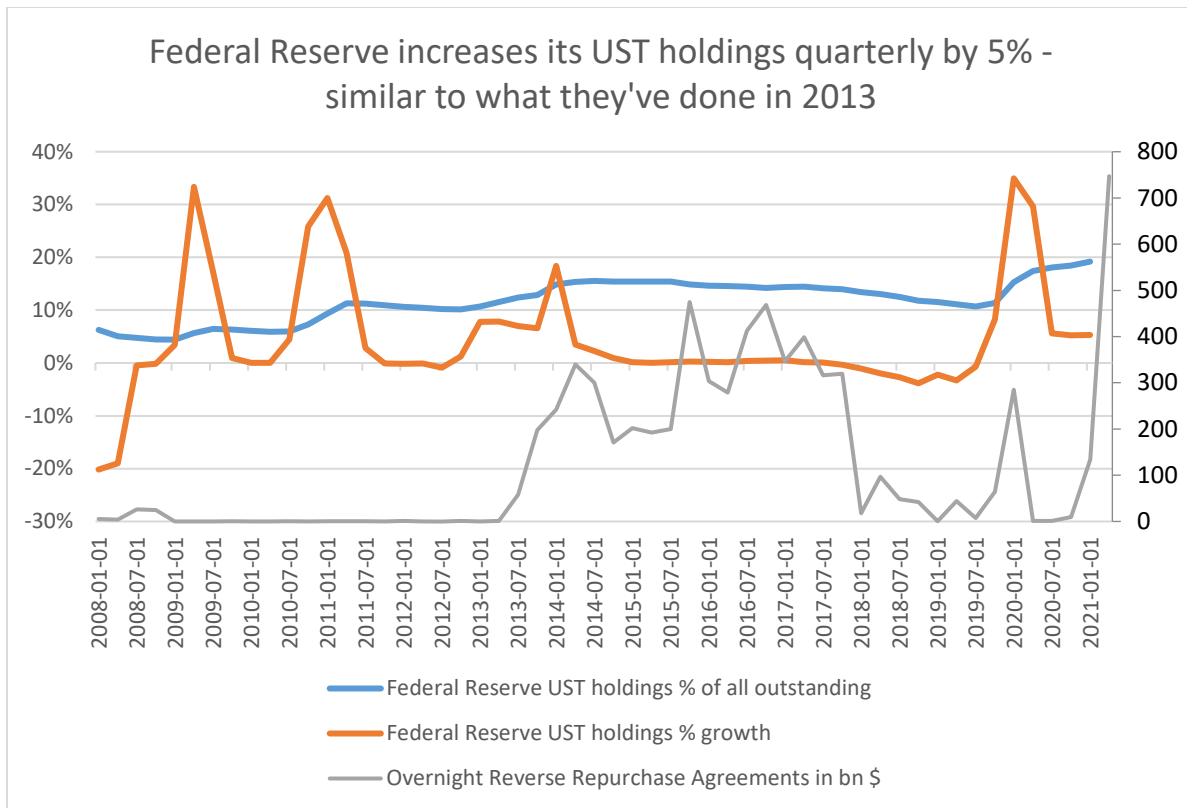
In 2013 the yield curve steepened rapidly while the dot plot kept rates flat out to two years. The Federal Reserve kept its UST holdings growing at a rate of 6-8%, while also growing its holdings as a percentage of the outstanding debt – All very similar to 2021. When the FOMC increased its dot plot by 40bps for two years into the future on the March 2013 meeting, the curve continued to steepen. However, when the FOMC increased its dot plot by another 50bps during the June 2013 meeting, the UST curve started to flatten quickly. Furthermore on May 22nd 2013, the FOMC introduced the “tapering” terminology, by

saying that they might reduce their asset purchase programme in the future. This combination of higher dot plot and tapering bond purchases, caused the UST yield curve to flatten quickly from there and continued to do so until 2019, six years on. However, before they could taper, they actually started purchasing more bonds and only began tapering by 2015. The dot plot has been very accurate back then, predicting the first rate hike two-years onward from 2013, the actual first rate hike did indeed happen 2.5-years onwards from 2013 in December 2015.

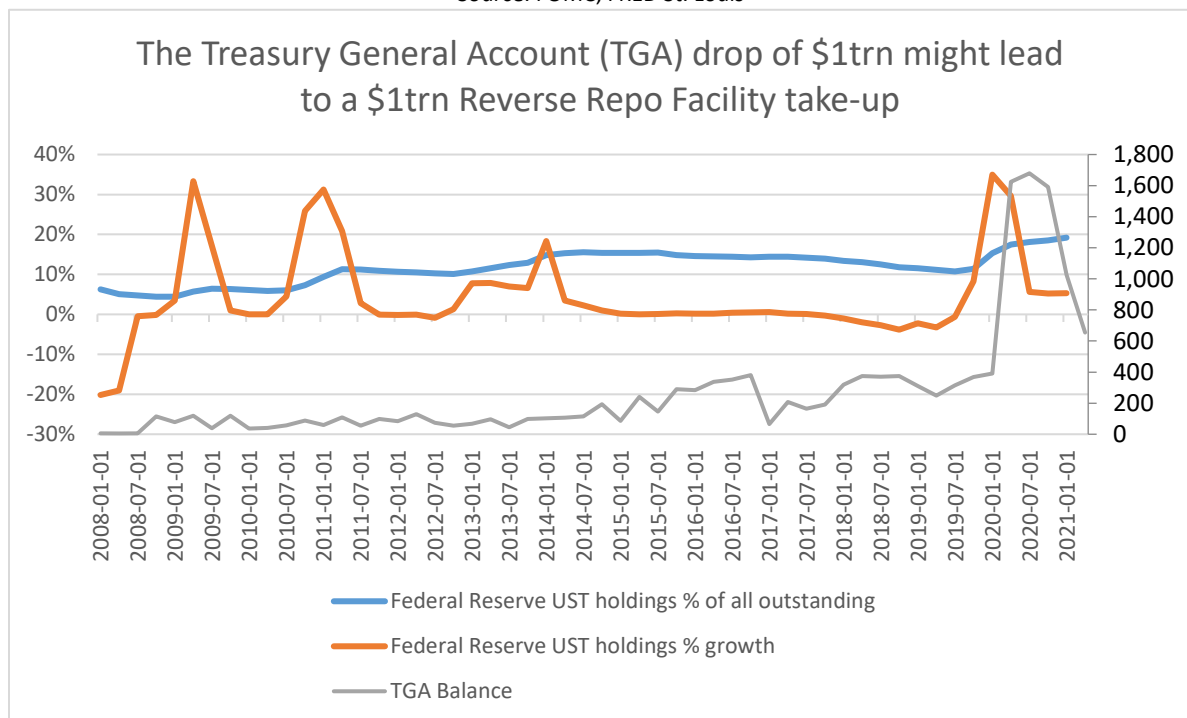


Source: SIFMA, FOMC, FRED St. Louis

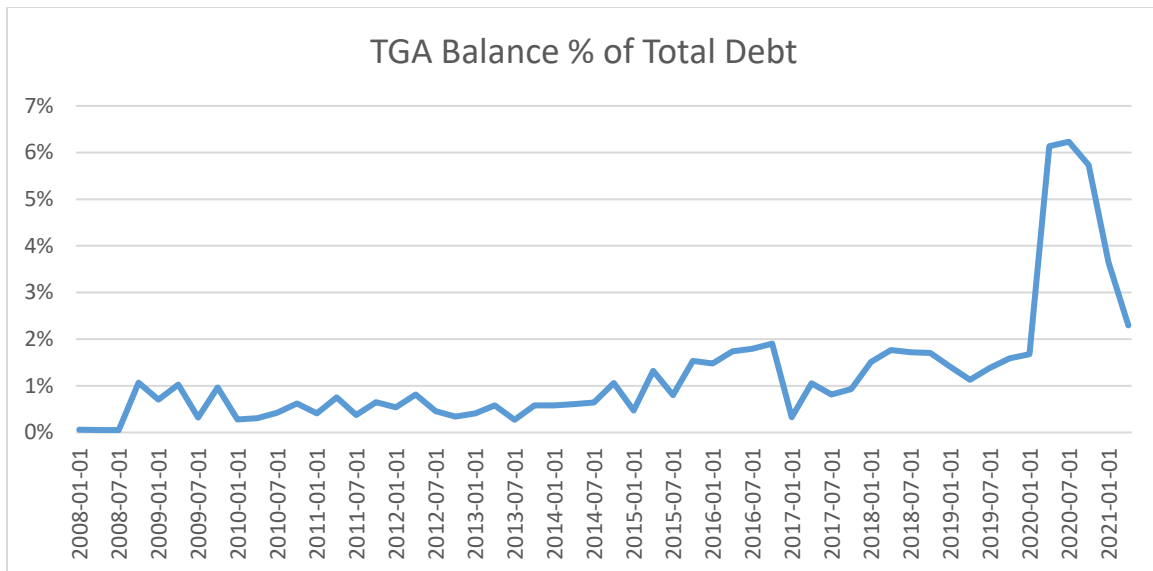
The three charts below show the similarities of purchases in 2013 vs. 2021 in more detail/clarity. The Reverse Repo Facility also grew rapidly in 2013, indicating excess liquidity in the system. Different to 2013, however, the Reverse Repo Facility is growing in line with the decline in the Treasury General Account (TGA). As the TGA balance dropped by around \$1trn, we might see the Reverse Repo Facility topping out at \$1trn. The TGA balance is likely to drop not much further from here, as the balance is now at around 2% of total debt outstanding – a percentage that's similar to the past.



Source: FOMC, FRED St. Louis



Source: FOMC, FRED St. Louis

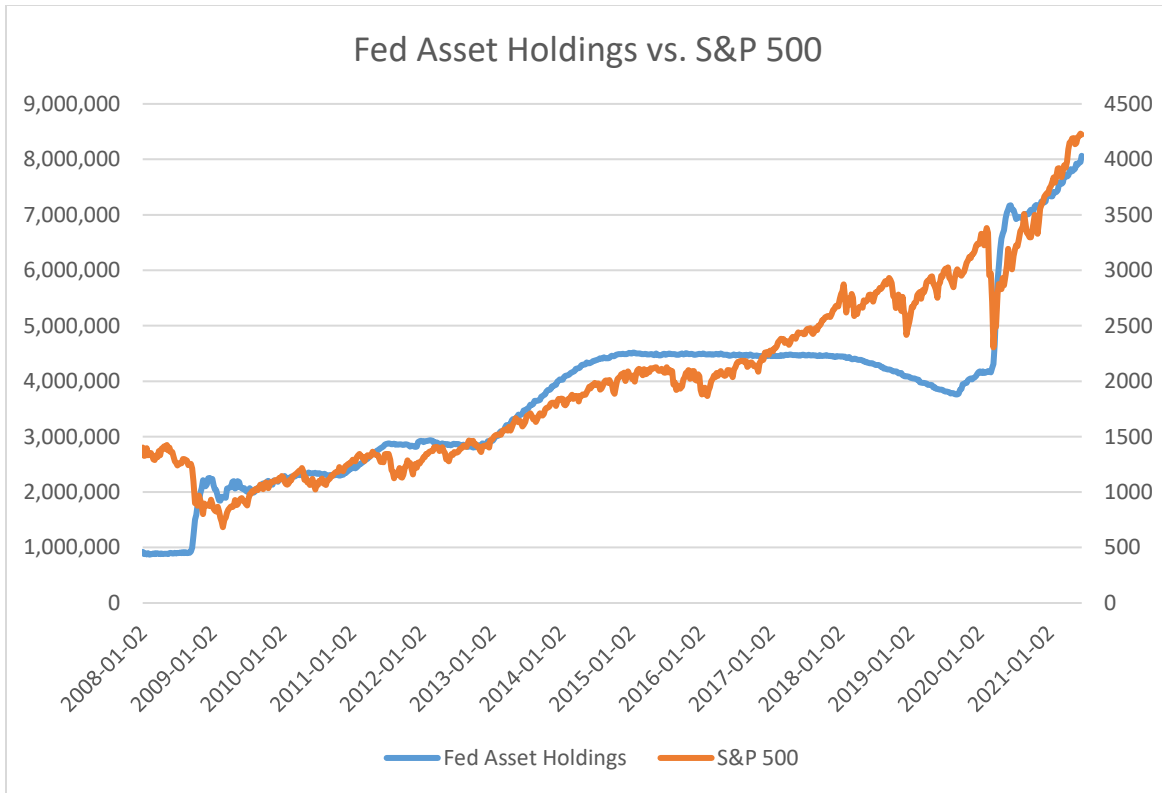


Source: FOMC, FRED St. Louis

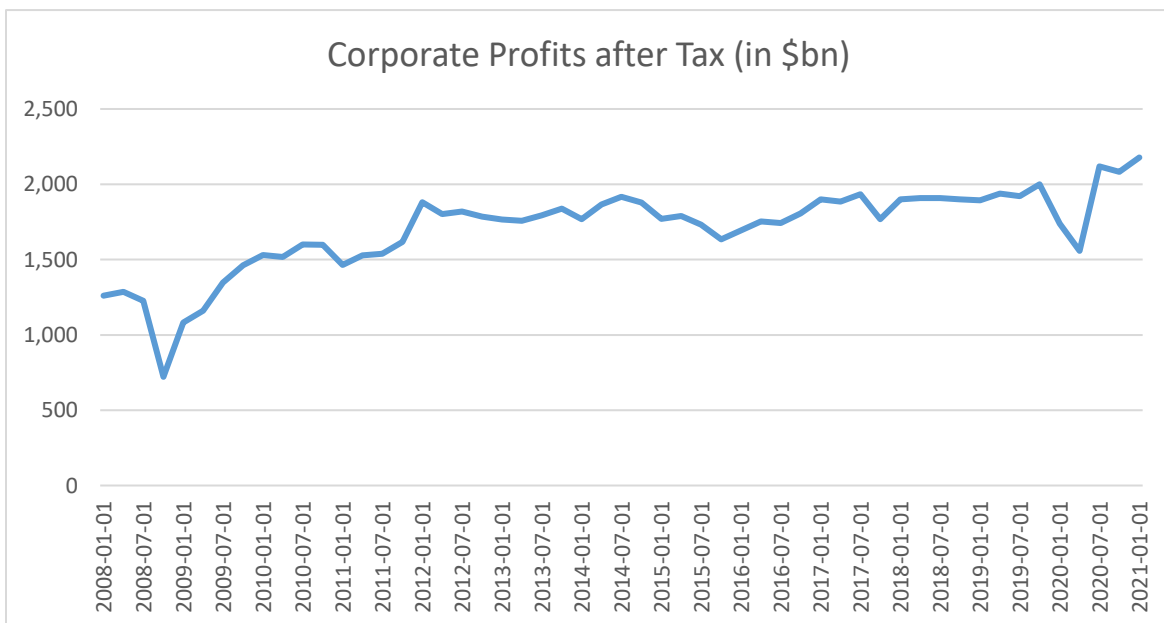
If we were to resemble the 2013 period, the recommendation would be long 30yr UST and/or a 2s10s flattening, i.e. buying 10yr, selling 2yr UST – although given it took actually 2.5 years before the Fed hiked rates and 1.5 to 2yrs before they tapered, it might be better to just go outright long 30yr UST or flattener via 3s10s for instance.

The equity market is looking quite vulnerable here, as can be seen in below two charts. The Fed's asset holdings and the S&P 500 had a pretty linear correlation. In 2017-2020 however, this correlation broke down with the S&P 500 outperforming the Fed's asset holdings, which actually dropped. The likely reason here is larger fiscal stimulus (partly driven by a reduction in the TGA balance) and lower corporate tax rates (introduced by Trump). Despite the lower corporate tax rate, corporate profits after tax (without inventory valuation adjustment and no currency adjustment) actually stayed pretty flat from 2017 onwards. Adjusting for inventory valuation and currency, we would have likely seen an increase, nonetheless.

With increases in corporate taxes and tapering on the horizon, bonds become more attractive to equity in relative terms. I continue to believe that while the 2013 period looks similar to the current period in terms of yield curve, the 1920/21 forgotten depression is very similar in terms of wealth-gap, higher taxes and general economic cycles/lockdowns & reopening of economies and its impact on prices. Equities look vulnerable here, but by selecting the right companies there are still reasons to be long here. Consumption has been really strong and nearly everyone, no matter their background, is trading stocks these days. The reopening trade is back on as vaccinations are strong, which makes oil explorers a good choice at current prices. A bullish view beyond 3 months, however, is difficult to form here.



Source: FOMC, FRED St. Louis



Source: U.S. Bureau of Economic Analysis, FRED St. Louis

The Dot Plot History

Year	Dot Plot Current Year	Dot Plot Next Year	Dot Plot 2 Years	Dot Plot 3 Years	Longer Run
2013-01-01	0.1	0.1	0.1	0.5	4.2
2013-04-01	0.1	0.1	0.5		4
2013-07-01	0.1	0.1	1		4
2013-10-01	0.1	0.1	0.8	1.8	4
2014-01-01	0.1	0.1	0.8	1.8	4
2014-04-01	0.1	1	2		4
2014-07-01	0.1	1.2	2.2	3.5	3.75
2014-10-01	0.1	1.2	2.2	3.5	3.75
2015-01-01	0.1	1	2.2	3.3	3.75
2015-04-01	0.4	1.6	2.5		3.6
2015-07-01	0.4	1.5	2.5		3.6
2015-10-01	0.4	1.4	2.6	3.4	3.5
2016-01-01	0.4	1.4	2.4	3.3	3.5
2016-04-01	0.9	1.9	3		3.3
2016-07-01	0.9	1.6	2.4		3
2016-10-01	0.6	1.1	1.9	2.6	2.9
2017-01-01	0.6	1.4	2.1	2.9	3
2017-04-01	1.4	2.1	3		3
2017-07-01	1.4	2.1	2.9		3
2017-10-01	1.4	2.1	2.7	2.9	2.8
2018-01-01	1.4	2.1	2.7	3.1	2.8
2018-04-01	2.1	2.9	3.4		2.9
2018-07-01	2.4	3.1	3.4		2.9
2018-10-01	2.4	3.1	3.4	3.4	3
2019-01-01	2.4	2.9	3.1	3.1	2.8
2019-04-01	2.4	2.6	2.6		2.8
2019-07-01	2.4	2.1	2.4		2.5
2019-10-01	1.9	1.9	2.1	2.4	2.5
2020-01-01	1.6	1.6	1.9		2.5

2020-04-01	1.6	1.6	1.9		2.5
2020-07-01	0.1	0.1	0.1		2.5
2020-10-01	0.1	0.1	0.1	0.1	2.5
2021-01-01	0.1	0.1	0.1	0.1	2.5
2021-04-01	0.1	0.1	0.6		2.5

Potential tax increases looming

- US corporate tax rate might increase from 21% to 28% effective from December 31st 2021. (UK from 19% to 25% in 2023)
- US individual income tax rate increases from 37% to 39.6% for top marginal tax payer effective from December 31st 2021. Thresholds will be indexed for inflation after 2022
- US capital gains taxes will turn into individual income tax rates + 3.8% NIIT (43.4% vs. 20.315% today) for >\$1mio earnings effective from December 31st 2021
- G7 agreement on minimum tax of at least 15% for global corporations with profit margins of at least 10% in the country they generate their profits in (would see 20% of any profit above 10% margin reallocated)

1920/21 – 2021/22 analogy

1918-1920 Pandemic	Current environment
<ul style="list-style-type: none"> • 1914-1918 economy was booming • Federal Reserve founded, partly to rein in inflation • Wealth gap between rich and poor widened • Tax on rich introduced (income >\$1mio) 	<ul style="list-style-type: none"> • 2016-2020 economy was booming • MMT was in discussion • Wealth gap between rich and poor at historic highs • Taxes were reduced, not increased
Spanish flu had 4 waves 1 st March 1918 2 nd late 1918 3 rd Beginning to mid 1919 4 th spring 1920	Covid so far had 3 waves 1 st March 2020 2 nd late 2020 3 rd Beginning to mid 2021 4 th ?
In 1919 at some point every 4 th British worker was on strike (as prices climbed faster than wages – high inflation)	In 2020/21 many British workers were striking, e.g. Centrica/British Gas, BT (threat), NHS (threat)
November 1919 Federal Reserve raised interest rates by 50bps to deter speculators	Federal Reserve began tapering corporate bonds in June 2021, likely more to come (equivalent November 2021)
3 rd November 1919 high of stock market, began declining slowly, then quickly in 1920 April/May 1920 cotton prices declined fast	We are at all-time equity highs... commodities partly at all-time-highs Equivalent of November 2021...
Between 1920-21 US GDP declined 23.9%, PPI -40.8%, industrial production -31.6%, stock prices -46.6%, corporate profits -92% New taxes were introduced after the sell off (12.5% capital gains tax)	Taxes are hitting wires as of 31 st December 2021 Equivalent of 2022-23

Source: "The Forgotten Depression" by James Grant