PREMIUM

Albert Edwards: "Will The BOJ Fiasco Be The Straw That Breaks The Back Of US Debt"

BY TYLER DURDEN

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> *"Massive supply of government bonds, most especially in the US, has become a key, if not the key, explanation for rising yields via rising term-premia. It's almost as if I have been transported back to the early 1980s when I started my career"* - **Albert Edwards**

And just like that, the Fed's ***"higher for longer"*** mantra is dead. At least that's the view of many Wall Street strategists, not to mention the market, this morning after Powell's FOMC speech delivery ended up being much more dovish than many had feared, which when coupled with the Treasury's less aggressive refunding issuance, has led to today's furious rally... and also a new note from Albert Edwards, in which the SocGen strategist writes that with the Fed now out of the way, what really matters is **1) the massive US bond supply,** and **2) the Bank of Japan (BoJ).**

Needless to say, we agree with the first, having first pointed out yesterday that despite the modest miss in the refunding total ($112BN vs $114BN), the bigger picture is still, well, catastrophic.

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Refunding aside, here is the bigger picture

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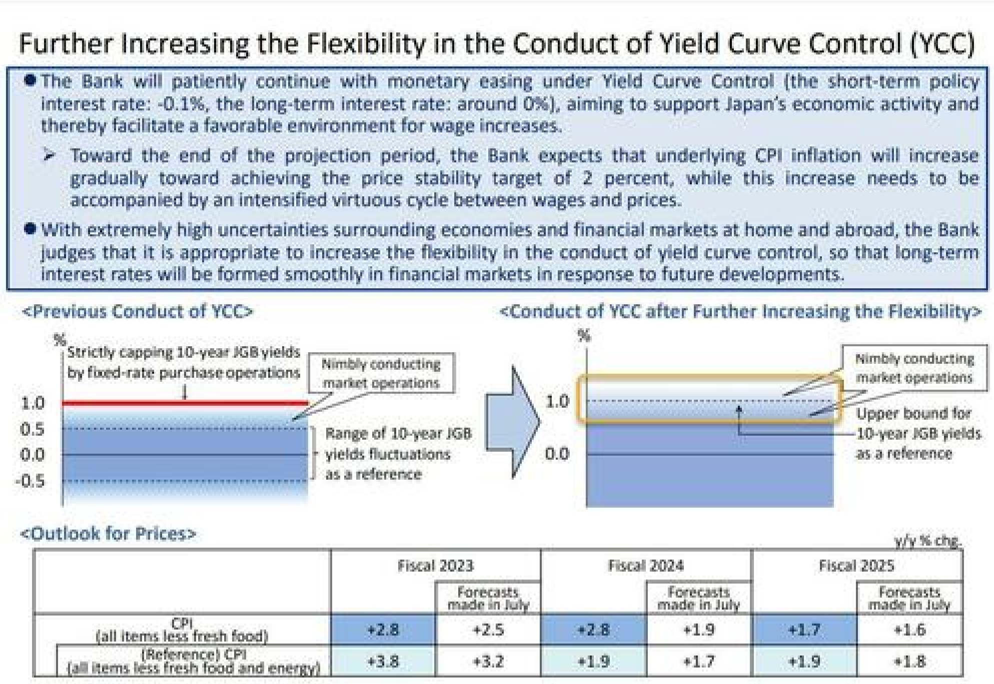
What about the BoJ?

Well, as BBG's Simon White said earlier, the next crash will likely be triggered by the BOJ finally starting to tightening (kicking and screaming no doubt) which is why - as Albert Edwards notes - it is *"highly significant that the BoJ has just rowed back on 'Yield Curve Control' (YCC) again"* (for those who missed it, here is the BOJ's own explanatory schematic of what is going on).



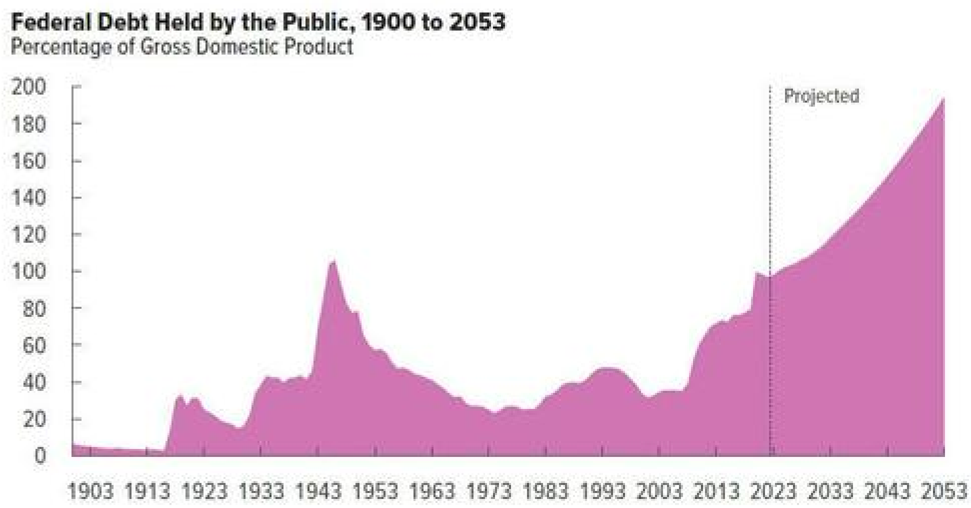
	Fiscal 2023	Fiscal 2023: Forecasts made in July	Fiscal 2024	Fiscal 2024: Forecasts made in July	Fiscal 2025	Fiscal 2025: Forecasts made in July
CPI (all items less fresh food)	+2.8	+2.5	+2.8	+1.9	+1.7	+1.6
(Reference) CPI (all items less fresh food and energy)	+3.8	+3.2	+1.9	+1.7	+1.9	+1.8

Source: BOJ

As a reminder, the last time the BoJ eased its foot off the YCC pedal in late July and increased the 10y ceiling from 0.5% to 1.0%, US treasuries went into a tailspin that has yet to end (although granted that took place at the same time as the Fed's last rate hike and also the last refunding announcement which shocked markets with how much debt will be issued).

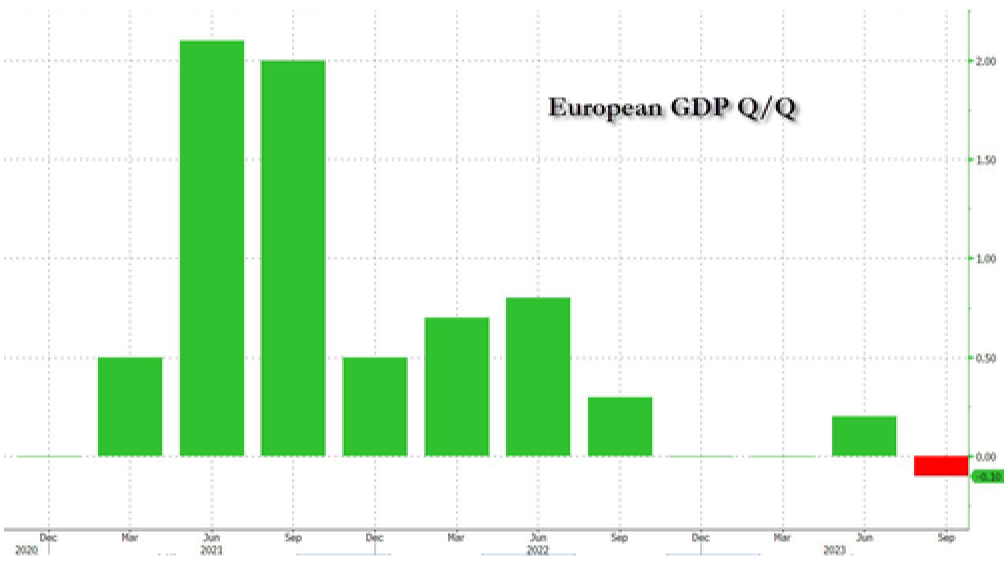
So, Edwards goes on, from August onward US treasuries (especially FX hedged US Treasuries, whose effective rate is slashed to about 1% or less) have faced increased competition from higher JGBs yields. That pressure intensified at exactly the same time as it became apparent just how gargantuan US Treasury issuance had become: *"This wasn't just a large bitter pill for the public to swallow, but one that got stuck in their throats, forcing 10y yields as high as 5%."*

But why worry so much about supply - which, *let's face it,* is **nothing new and anyone who cared knew long ago that the US is on an unsustainable fiscal path as even the CBO admits...**

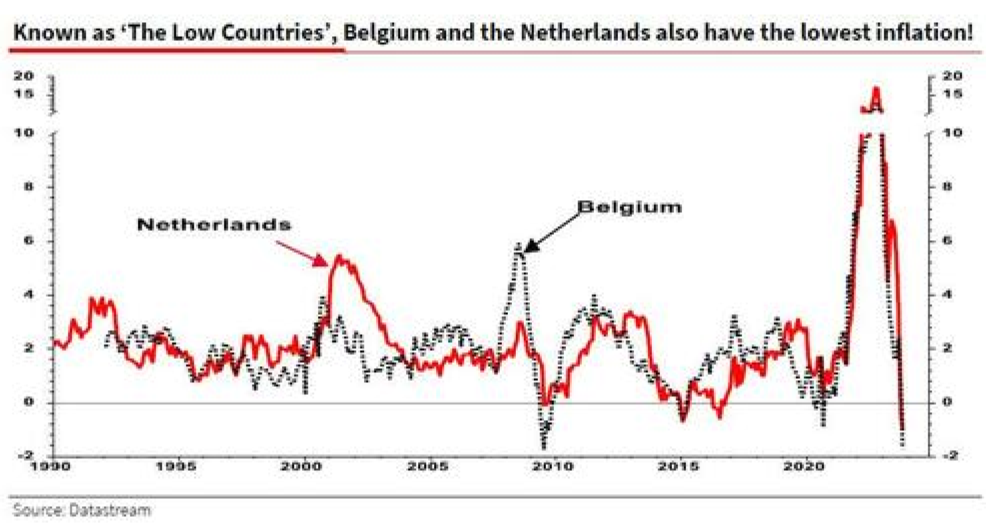


... and what really matters for yields is when the flight to safety of US paper takes place, i.e., the next recession.

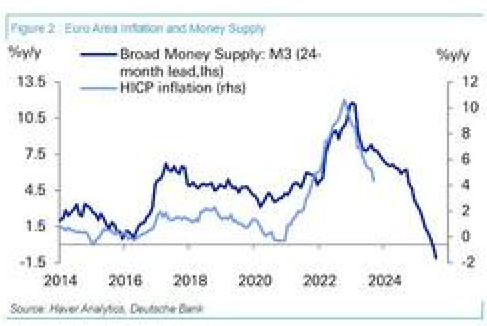
Addressing that issue, Edwards agrees that when the US does eventually slide into recession, **the cyclical factors will dominate supply concerns:** "That is the normal way of the investment world." And to that end, the SocGen strategist says that we need to keep one eye on inflation trends to sense how quickly central banks might be willing to cut rates. Sure enough, as [noted yesterday](), weaker than expected eurozone Q3 GDP (down 0.1% QoQ) and October CPI inflation data (dropping to 2.9% from 4.3%) threw some useful straws into the wind this week.



Edwards shows a chart of headline inflation in Belgium and the Netherlands, both of which saw headline CPI move into deflation (down to -1.7% and -1.0% yoy respectively) as high energy costs unwound. And while core CPI inflation remains sticky in both countries, **it is notable that this pace of decline in the headline CPI has rarely ever been seen.**



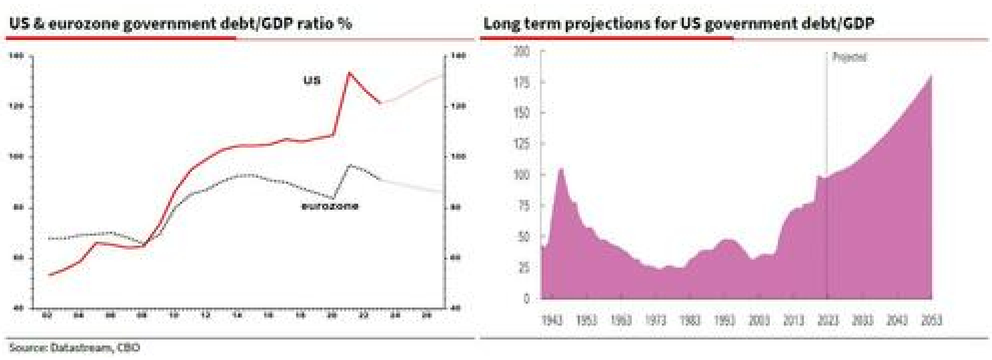
"If this is a straw in the wind for larger G7 economies, *then any unfolding recession could trigger an abrupt handbrake turn in policy to mitigate the immediate recessionary pain, leaving any residual sticky core inflation to be addressed in the next cycle",* writes Edwards, and DB's Jim Reid agrees with him, similarly noting that while correlation doesn't equal causation, "inflation has recently tracked the developments in money supply with an 18-month lag in the US... For Europe, the relationship is slightly complicated by the additional and extreme energy shock that the continent experienced due to the war in Ukraine. However, the trends are similar with a slightly different lag."



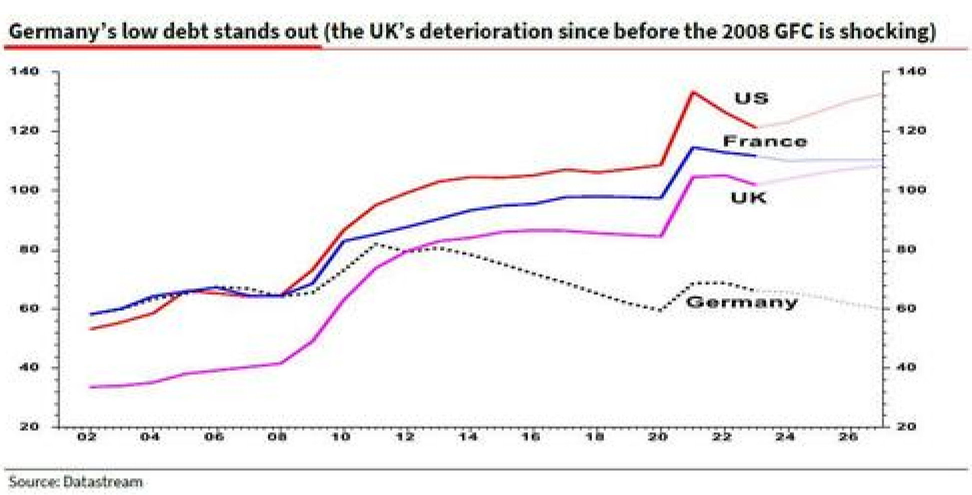
To Edwards, this all suggests that **"the Fed's higher for longer interest rate mantra may haunt the markets through multiple economic cycles rather than end with this cycle."** Back in the mid-1990s the Fed called this '[opportunistic disinflation]()', and *the window of opportunity to dis-inflate is almost over for this cycle.*

That said, while structural deflation appears imminent, for the time being people remain furious at residual inflation with Edwards citing Jeroen Blokland who writes that “people are angry when it comes to inflation. And they have every right to be. ***The chart below shows the price LEVEL, not the price change. Virtually every item you buy is (a lot) more expensive than 2 years ago***”.

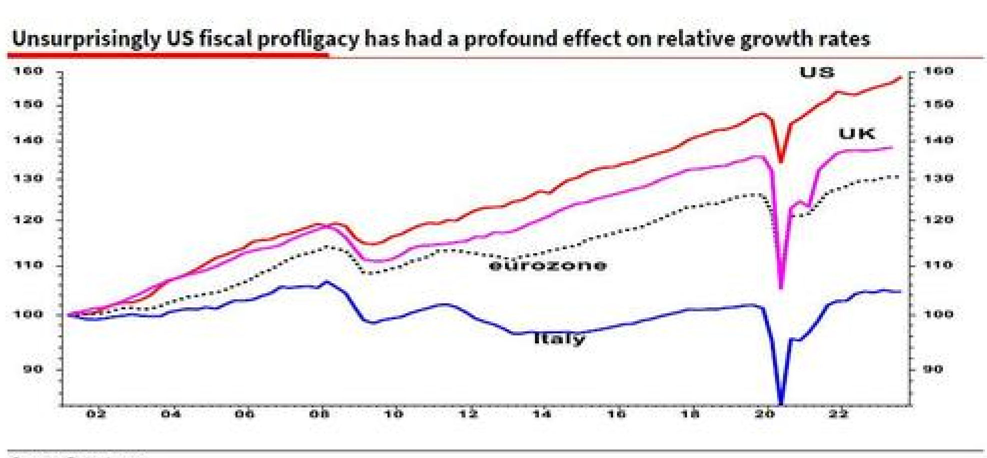
There is another reason why Europe's recessionary wave has not yet broken on US shores, and it has to do with what we called Biden's stealth $1 trillion stimulus (see "[Here Is The $1 Trillion "Stealth Stimulus" Behind Bidenomics]") and which everyone has figured out by now is the only reason why Bidenomics hasn't imploded. Edwards points to a [recent WSJ article]on how US fiscal profligacy contrasts with the fiscal parsimony of the eurozone (see left hand chart below, which includes IMF projections), and adds that "***If you think the current 120% of GDP is too high, take a look at the CBO’s long-term projections. Wow!***" Of course, regular Zerohedge readers are familiar with both charts.



Which is not to say that all of Europe is practicing fiscal celibacy: according to the SocGen strategist, the low aggregate eurozone debt/GDP data **comes only courtesy of extreme German fiscal rectitude.** The rest of the eurozone (and indeed the UK) are closer to the US’s dystopian situation of spending like a drunken sailor... but at least the US has a reserve currency, what does Europe have?

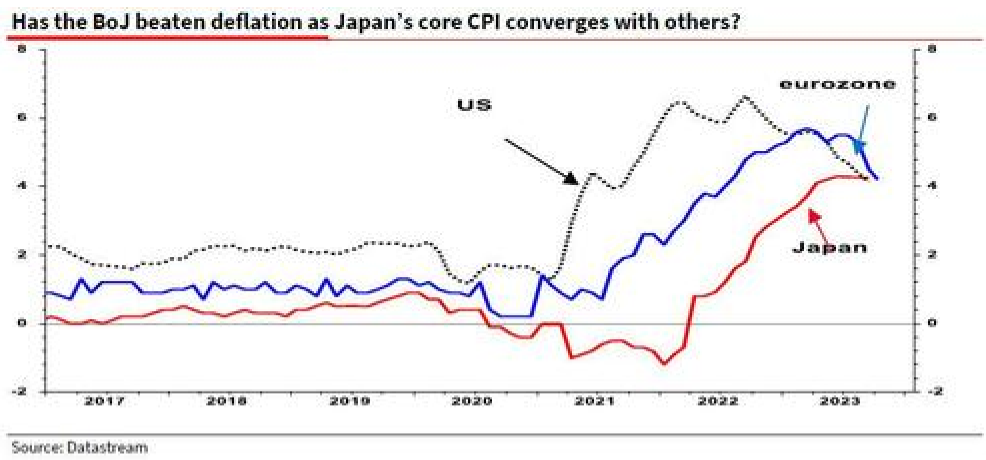


Which brings up the $64 trillion question: **who could have forecast that the US Administrations (both Republican and Democrat) would go bonkers?** Well, ***everyone*** since it was hardly rocket science to predict that when the Fed is throwing QE like confetti, these huge deficits would be financeable... but those days are long gone. Despite this, "curiously few in the US seem scared (for now) that ‘bankruptcy’ lies ahead", according to Edwards although we would beg to differ and note that US CDS is trading near the highest level since the March banking crisis.

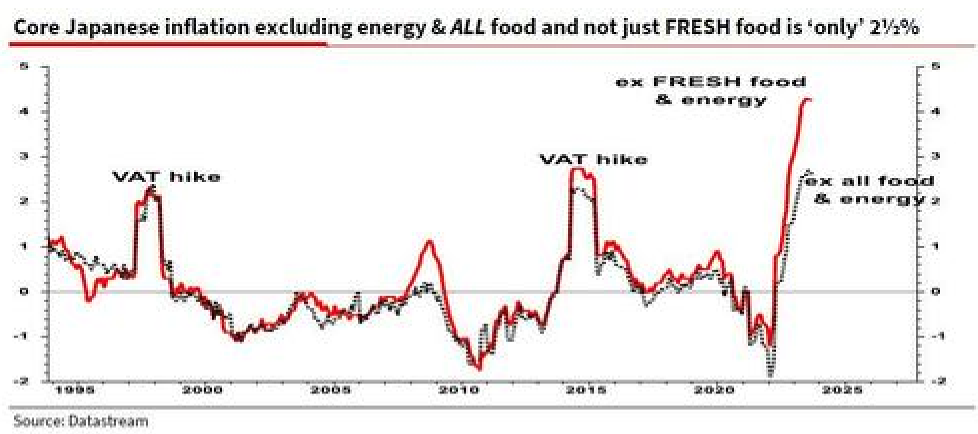


So in a global environment where even the smallest deviation from long-established financial norms and levels could have catastrophic "butterfly-wings" consequences, might the BoJ backing away from YCC "**be the straw that breaks the back of the unsustainable US debt situation?**"

Making a full circle, Edwards notes that the BoJ’s recent YCC tweaks certainly reduce the attraction of US bonds, **but could the BoJ go much further and halt YCC?** Some who think so have focused on Japan’s core CPI having converged with core inflation elsewhere. Is deflation beaten?



It's not all bad news: *not everyone* expects the BOJ to finally do the right thing (recall Simon White wrote that "t**he BOJ never misses an opportunity to miss an opportunity.** Once again, the bank chose not to exit its ultra-loose policy stance and allow the huge market imbalances building up to ease. Instead, we got a technocratic tweak to yield curve control (YCC) and no increase in the only negative policy rate left in the world"). He notes that Jin Kenzaki, SG's Japan economist, is sceptical of an early YCC exit. Indeed, this week BOJ Governor Ueda told the press, *"we still haven't seen enough evidence to feel confident that trend inflation will (sustainably hit 2%)"*. One reason is that 'core' inflation is not peaking out at 4%+ but at a much lower 2.5% when you exclude **ALL** food and energy.



This, Edwards suggests, may buy the US Treasury some time to get its fiscal house in order.... something they unfortunately never do.

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