# Reflation Nation (First of Two Parts)

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In February 1983 your correspondent bought his first house with a 13% 30-year fixed rate mortgage. Why fixed? Because the year before, the 30-year had soared to almost 18%. Higher interest rates were a fact of life. We stubbornly stuck to the fixed rate option in succeeding refis over the next two decades.

Since the Volcker Shock of 1980 wrung inflation out of the US economy, interest rates have declined. That trend favored generations of bond investors (see our *Chart of the Week*). "It's been a wind at our back for a long time," one top credit investor told Bloomberg. "We don't have the wind in our face yet. This is what the conversation on inflation is really about."

Bond values are threatened in the new world order. Long-term interest rate fears, propelled by pent-up consumerism and an almost $2 trillion stimulus package, are clashing with the Fed's dovish jawboning around relaxed inflation vigilance.

What's the balance between the Fed keeping interest rates low enough to drive down unemployment, and overstimulating the economy to where inflation becomes tough to manage without Volcker-like consequences? "This is all uncharted and hence uncomfortable territory for all of us," one economics professor reported.

The reflation trade, which implies expectation of both economic growth *and* inflation, is simply the reverse of what happened during Covid. GDP cratered in 2Q 2020 by 30% and inflation dropped to near zero. Growth swung back dramatically in 3Q and inflation rose moderately through year-end. Add to that rising interest rates, and you have reflation akin to the post-GFC period.

When could a classic recovery become runaway inflation? Economists today are divided on this point. Some worry that the Fed is acting, not when the economy is in a recession, but after it's recovered. Throw in the Biden rescue package and you have a recipe for overheating.

Others agree with Chair Powell that sectors like retail are in deep recessions, and a long way from healthy labor markets. Will vaccines and herd immunity subdue Covid and change behaviors to encourage full commercialization of consumer-facing businesses?

Meanwhile the government bond market has been voting with its feet. Traders engaged in record speculative short-selling last week; the ten-year Treasury briefly touched 1.60% before easing back.

Hard to tell whether Mr. Market will have the same influence on Mr. Powell as it seemed to in 2019. Back then the Fed reversed course after eight successive hikes and cut rates that August by 25 bps. On the other hand, the 2013 Taper Tantrum, prompted by the Fed's proposed pull back on bond purchases, went for naught.

Which result will bond investors' 2021 Addition Conniption produce?

*Next week: What do higher rates mean for credit markets?*