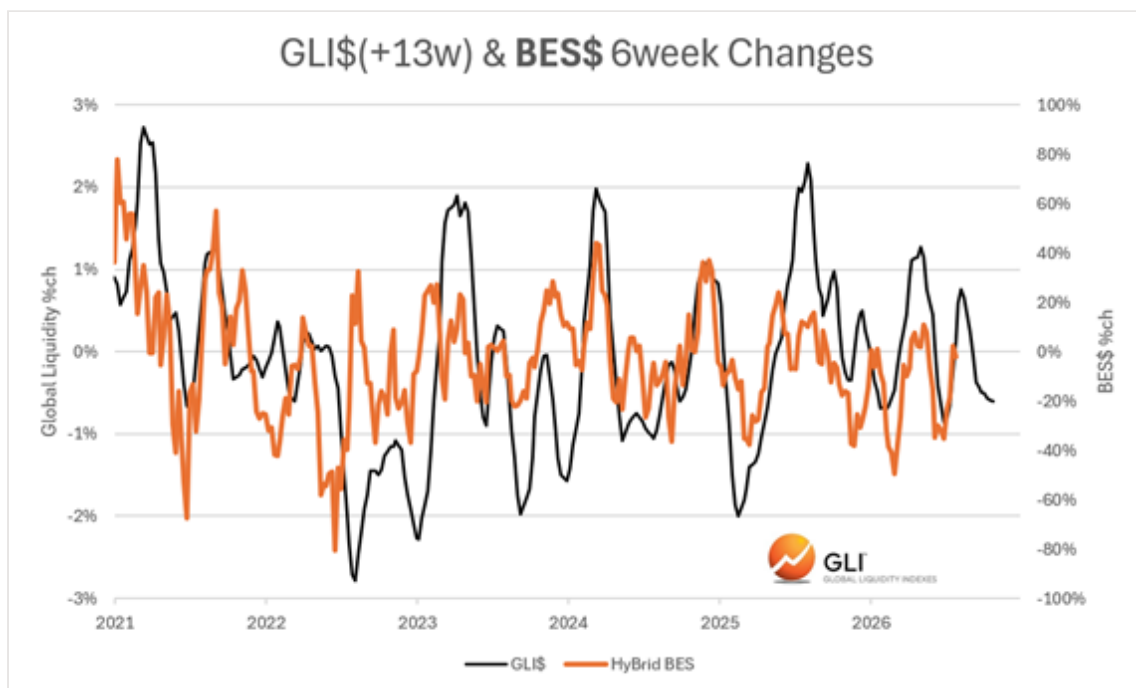


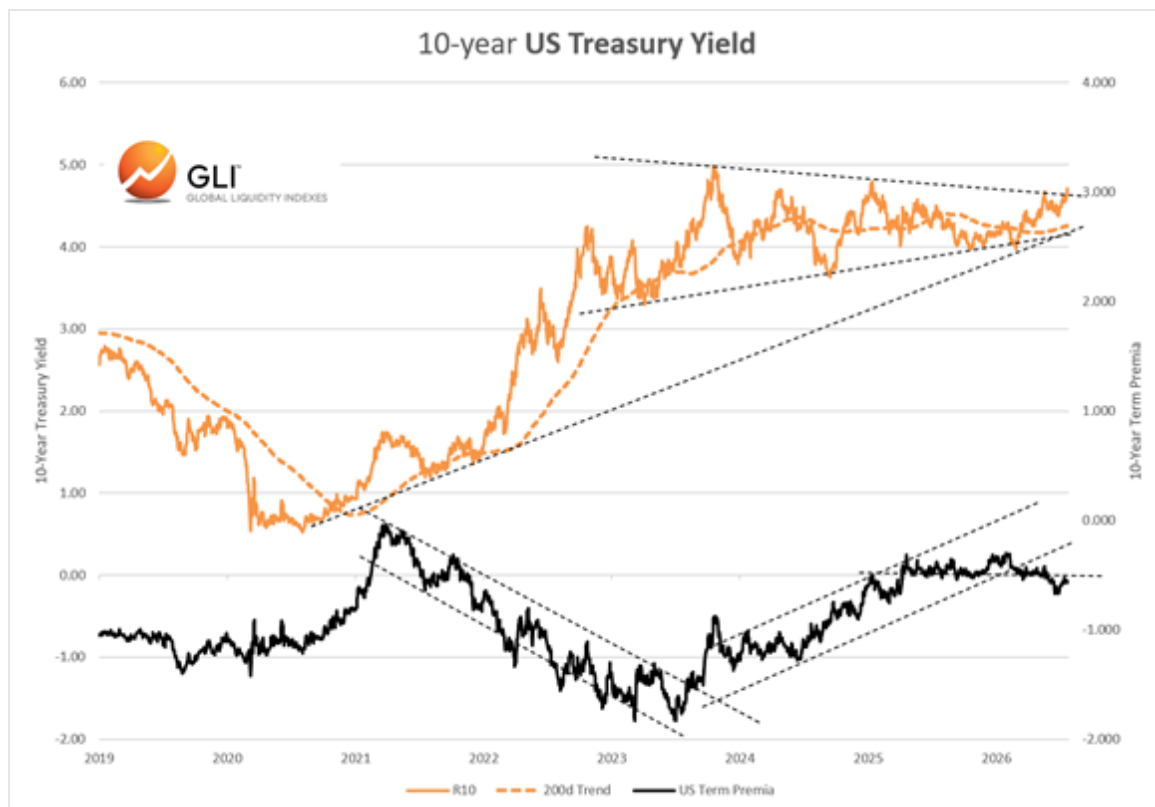
The Future Costs of Current Suppression

Have policymakers been deliberately holding down oil prices and bond yields?

Late investment cycle signs continue to accumulate, from bearishly flattening yield curves, through strong commodity markets to persistently positive economic data surprises. Weekly Global Liquidity data also reveal choppiness, as the chart below confirms, but with a trend towards weakness that has proved sufficient to pull down the liquidity-sensitive BES\$ crypto basket (60% BTC\$; 30% ETH\$ and 10% SOL\$). We explain this slide mostly through the crowding impact of a rapacious real economy, but there are also **gathering signs that several central banks are starting curtail liquidity impulses.**



This shift is being picked up by bond markets. Consider the mighty US Treasury 10-year benchmark yield. This looks set to break out from its recent chart pattern (orange line) driven by rising rate expectations and without the help of higher term premia (black line). Indeed, the flat-lining (to modest falls) in term premia point to investors' growing appetite for 'safety'.



Subscribed

Key Points

- Global investment cycle is 'late' phase, we describe as *Speculation*. Downward inflection in **Global Liquidity** is being driven by strong business activity and increasingly by **tighter central banks**
- Evidence of 'lateness' confirmed by flattening yield curves, weak gold and Bitcoin, firmer commodities, persistent economic data surprises and AI-mania
- **Oil looks cheap relative to gold:** the gold-to-oil ratio remains far above its long-run average, implying a much higher equilibrium oil price if gold is correctly priced
- **Long-term bond yields look too low relative to nominal GDP:** risk-adjusted Treasury yields are lagging the pace suggested by US money growth and survey data
- **Policy suppression may become self-defeating:** cheaper energy and lower yields stimulate nominal growth, which then increases pressure for both oil prices and yields to rise
- **The investment risk is an abrupt adjustment:** Japan's experience shows that once suppressed yields break higher, the move can overshoot as investors demand an additional risk premium

In our view, these pressures point more towards a repricing of risk assets, than a recessionary collapse in earnings. Even so, their full impact is being cushioned by subtle policy intervention. **This veneer may itself be starting to crack, threatening a bigger future sell-off. Remember, there ain't no such thing as a free lunch!**

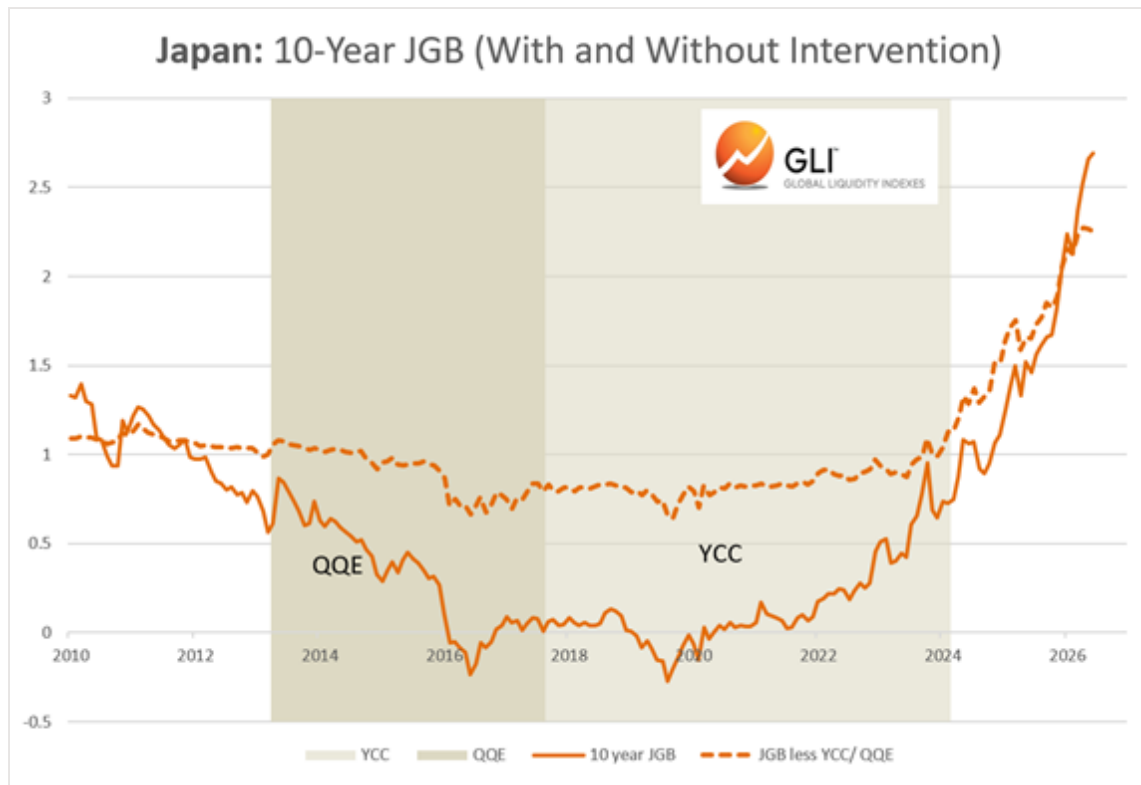
Evidence how the long-term US interest rate and the oil price — two of the most important prices in the world economy—appear misaligned with the underlying buoyancy of economic fundamentals. \[A third mispricing – the Chinese Renminbi – is reserved for another piece.\]

Policymakers have strong incentives to keep these key prices suppressed. Lower oil prices support consumption and corporate profit margins, while lower long-term bond yields ease financing pressure and support asset prices. Yet this strategy carries a significant cost: **suppression can create a negative feedback loop in which stronger nominal growth lifts energy demand and pushes renewed upward pressure onto bond yields.** In short, it is ultimately self-defeating.

Submerging The 'Beachball'

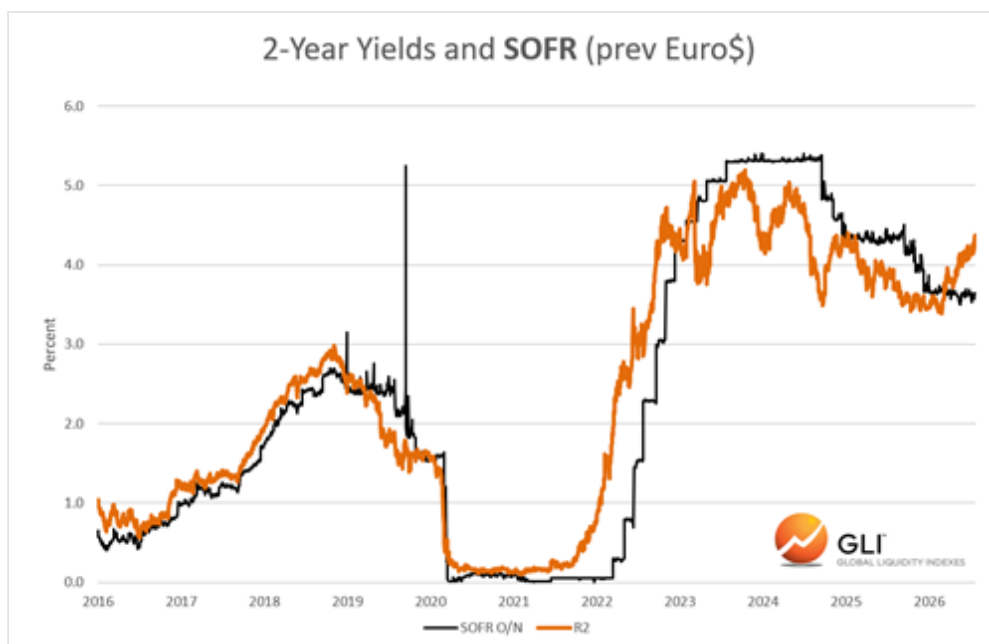
Oil prices shape household spending power, corporate margins, inflation expectations and external balances. Long-term bond yields influence mortgage rates, corporate borrowing costs, equity valuations and the sustainability of government debt. When either price is held below the level implied by fundamentals, the short-term impact may look supportive. Over time, however, the risk is that imbalances accumulate beneath the surface.

The more US long-term yields and oil prices are suppressed, the greater the eventual adjustment may become. **Holding down the long end of the yield curve is like holding a beach ball under water: the longer the pressure is maintained, the more forcefully it may rise when released.** Japan offers a cautionary example. After years of quantitative easing (QE) and yield-curve control (YCC), Japanese government bond yields have lately surged. Risk-adjusted yields have risen sharply, while actual yields have overshoot as investors demanded an additional risk-premium cushion. In barely more than two years, JGB yields rose by roughly 200bp.

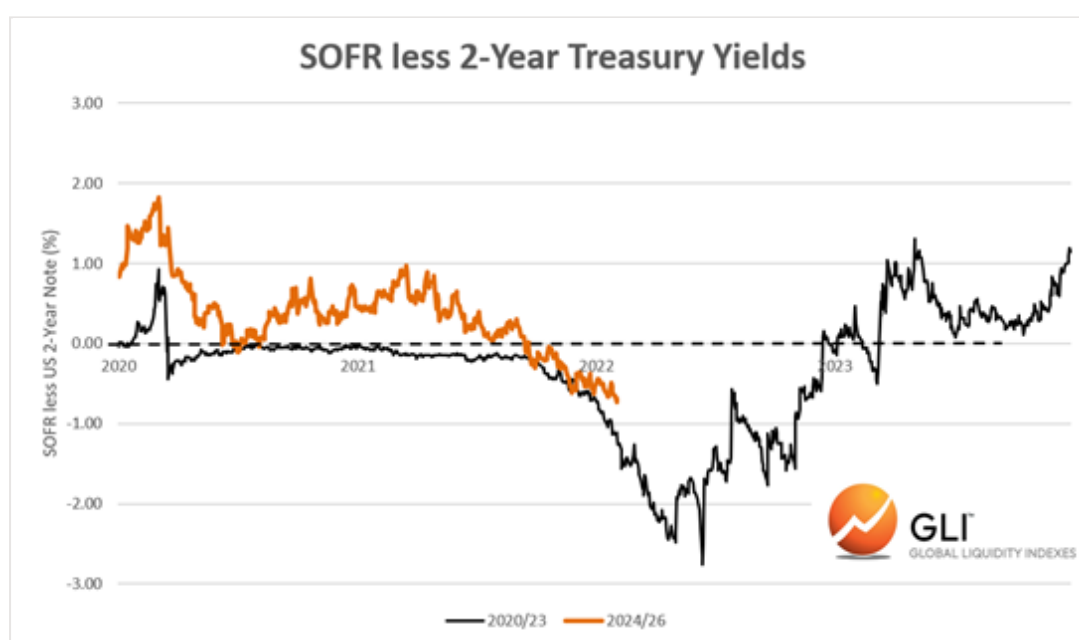


Squeezing one end of the yield structure tightly, like a balloon, leads to a bulge elsewhere. Not surprisingly, pressure is already building at the short end of the US curve. The Federal Reserve may ultimately have to acknowledge this by formally tightening monetary policy. This fits our general philosophy that **long-rates ultimately determine short-rates**, with central banks, in practice, only bit-part players when trying to set policy rates.

One useful gauge of these displaced tensions is the spread between SOFR repo rates and the US 2-year Treasury yield. SOFR rates reflect financing costs in the crucial overnight repo markets, while 2 year Treasuries are dominated by future policy rate expectations. A large negative spread (i.e. SOFR below Treasury yields) forces borrowers into the very short-term markets, signalling US monetary conditions are shifting towards greater tightness and demanding accommodation by the Fed.



The similar path towards a wider SOFR less Treasury spread during 2021/22 saw 25% wiped-off Wall Street and Bitcoin crashing by a whopping 75%. The following chart tries to compare these two periods by overlaying the current timeline (2024-26) on the earlier (2020-23) episode. Looking ahead, this suggests at least another six months of widening spreads and tightening monetary conditions.



Oil Looks Undervalued Relative To Gold

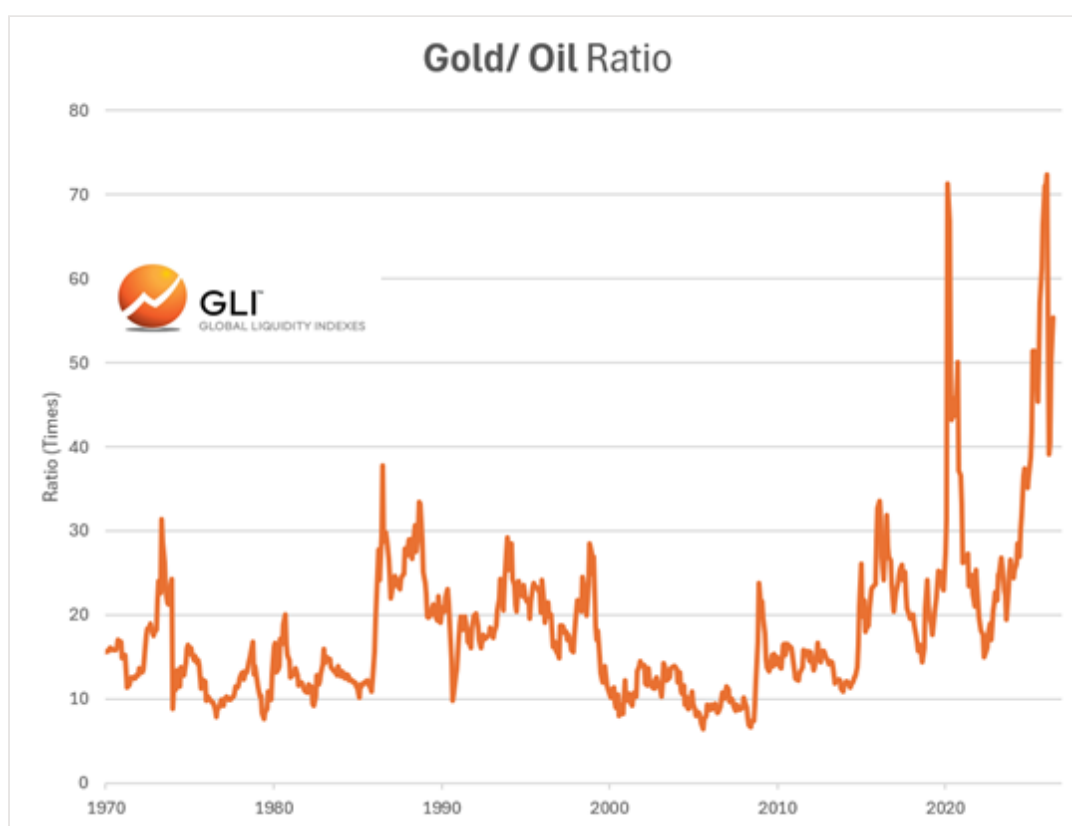
Measured against gold and other commodities, oil still appears inexpensive. A simple historical benchmark is the gold-to-oil ratio, which has averaged a little above 20 times since 1970.

Historically, large dislocations in the gold-to-oil ratio have tended to converge back towards equilibrium within three to four years. The COVID-era spike is one example. At close to 60 times, today's ratio therefore looks highly stretched.

We accept that the gold-to-oil ratio is not fixed. The newfound attractions of gold as a US dollar substitute must have some impact, independent of oil. On top, the ratio will be influenced by the relative long-term extraction costs of the two commodities. Those costs can change over time, but it is still difficult to justify a sudden three-fold shift in the relationship.

Gold itself remains sensitive to monetary inflation, debt accumulation and reserve diversification. Continued money printing and central-bank accumulation therefore supports the case that the bullion price is well underpinned.

Using the long-run average gold/ oil ratio to infer a target oil price from a gold price of around US\$4,000/oz implies oil above US\$150 per barrel, and potentially closer to US\$200. On this basis, current oil prices appear suppressed relative to a broader commodity benchmark. The key question is which price is wrong: gold, oil, or the ratio between them?



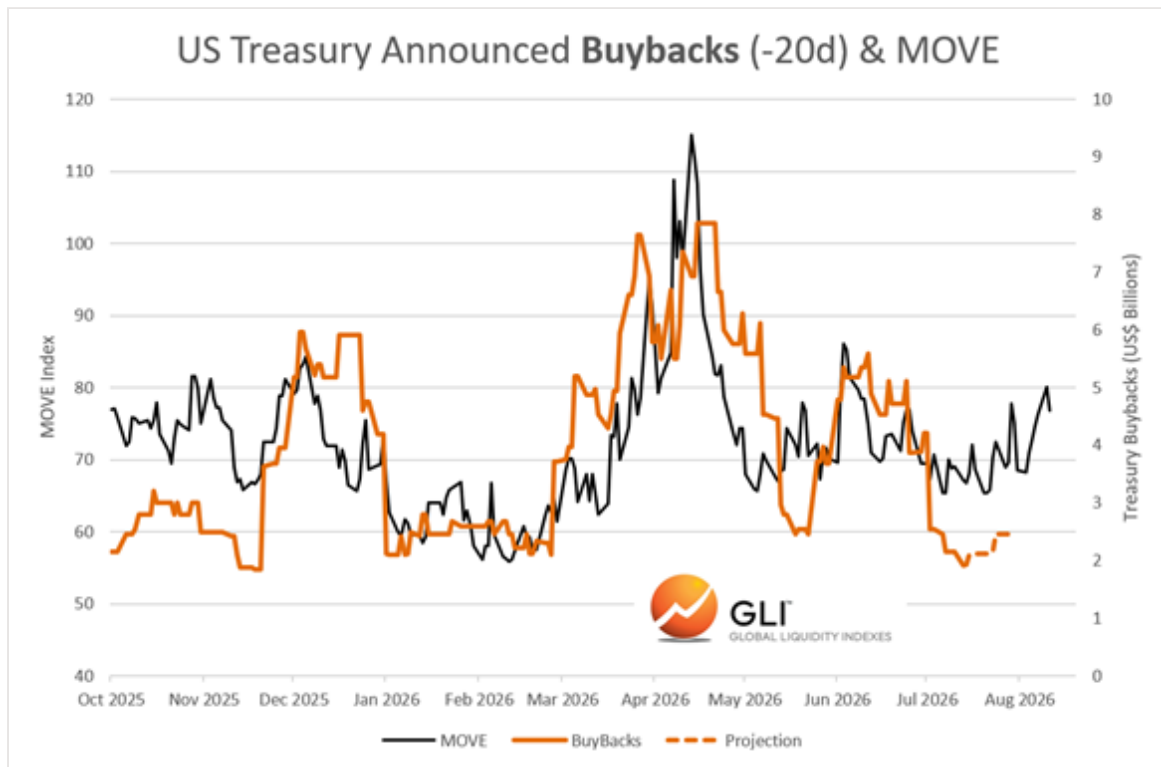
Several temporary factors have helped contain oil prices. Higher US oil exports, the rundown of strategic reserves and creative sourcing of alternative supplies have all limited the price impact of Iran-related tensions. In addition, China's recent policy cooling appears to have reduced Chinese oil-import demand. These measures can delay upward pressure, but they are unlikely to remove it permanently. In short, we figure that, even on generous assumptions, the misalignment of the oil price looks too big.

Long-term Bond Yields Look Low Relative To Nominal Growth

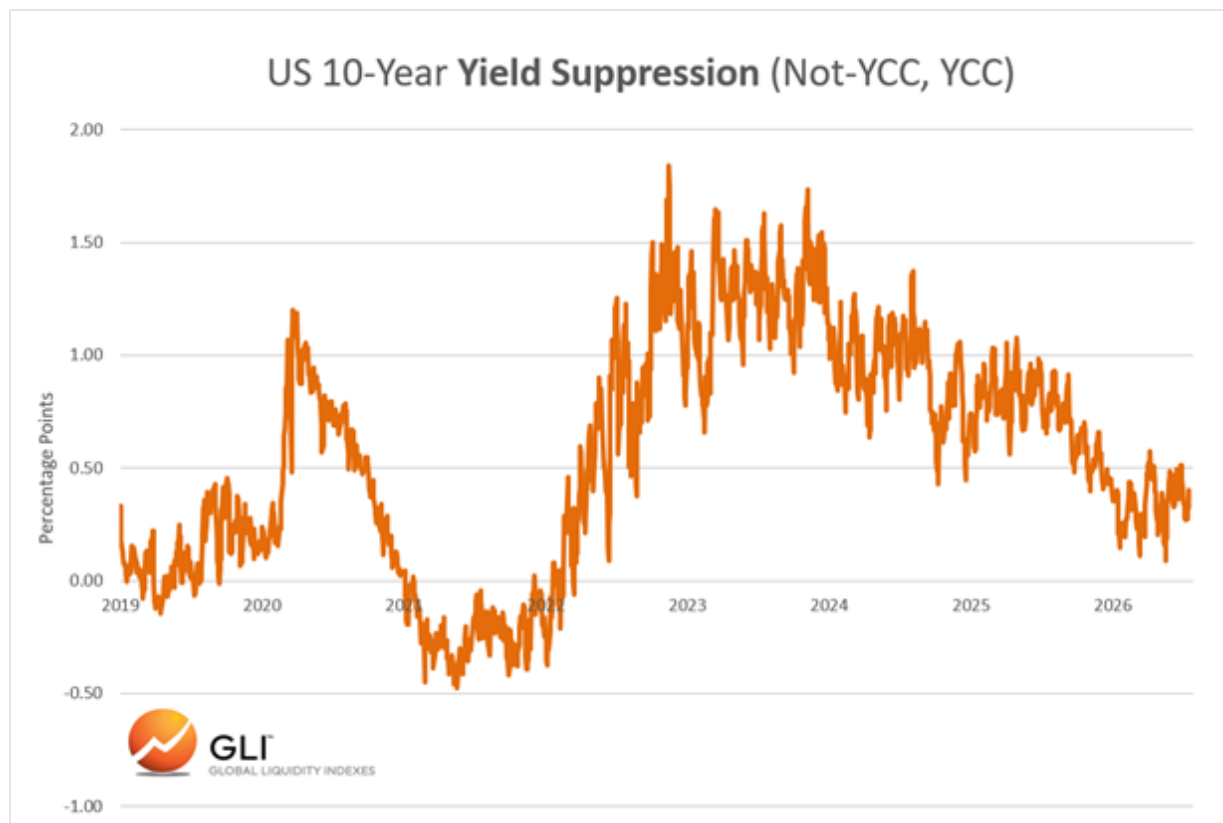
The second major price misalignment is in US long bonds, notably the benchmark 10-year Treasury yield. Relative to underlying US nominal GDP growth, long-dated yields appear too low. Several mechanisms may be

contributing to this suppression, including generous repo financing, heightened basis-trade activity, limited long-dated coupon supply and persistent Treasury buybacks.

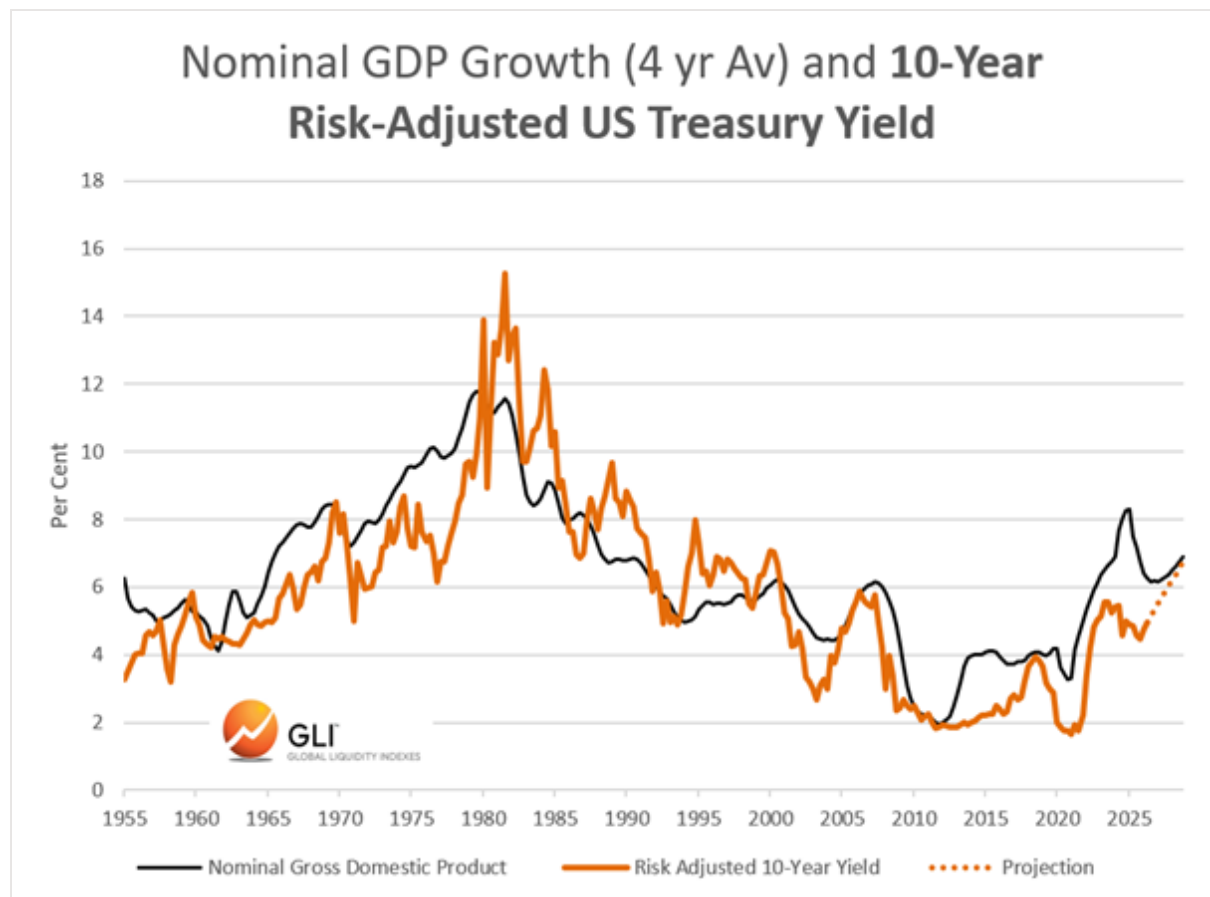
We describe these policy-related mechanisms as *yield volatility control* (YVC), rather than old-fashioned *yield curve control* (YCC), per se. The relationship between the MOVE index of US Treasury volatility and cumulative Treasury buybacks is suggestive: typically, each 10-point rise in the MOVE index is associated with roughly US\$1.3 billion of additional buybacks. See next chart.



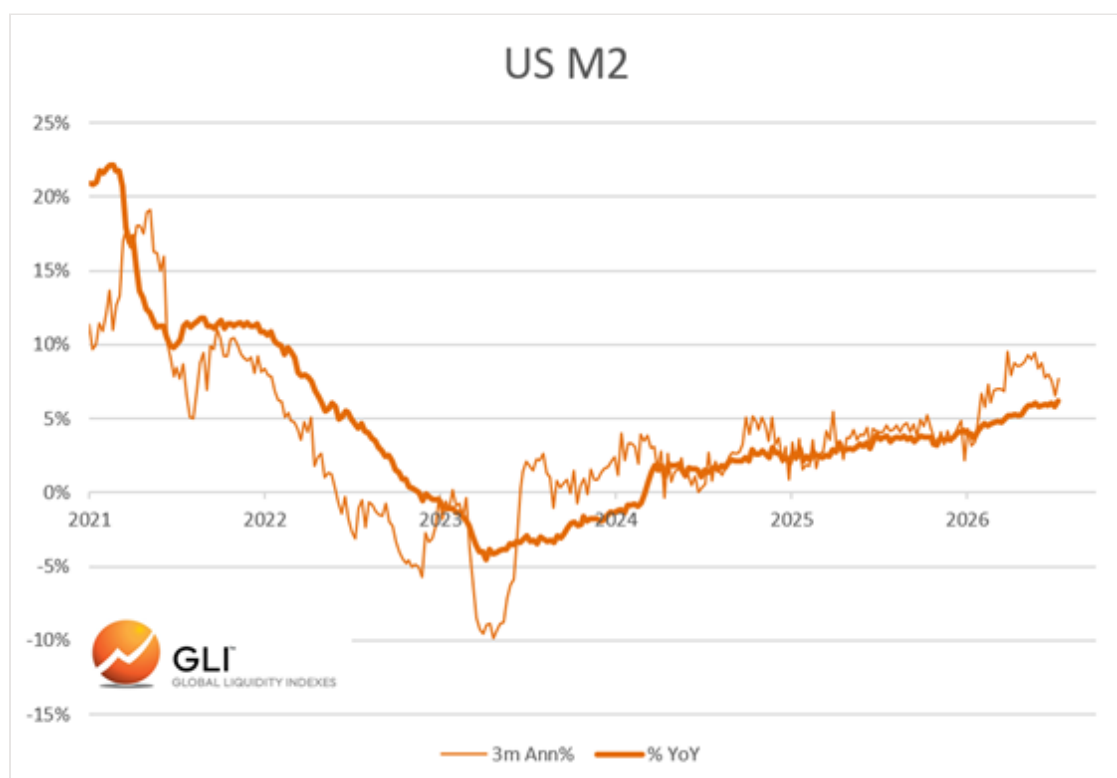
Estimates of this *yield suppression* can be bootstrapped from the US mortgage market using comparable risk-free securities. We show that Treasuries currently trade at around a 40bp discount to equivalent-duration MBS. This bias was far larger in late 2022, when it tested 180bp.



Yet, the best measure of the shortfall is to compare underlying, or risk-adjusted, Treasury yields with the trend growth rate of US nominal GDP, using a four-year rolling average. See chart. Current estimates put US nominal GDP growth at around 6–8% per annum. That range points to materially higher future Treasury yields, especially if nominal GDP growth accelerates and suppression techniques weaken.



Weekly US M2 money-supply data supports the case that nominal GDP is stretching limits. M2 mainly captures money circulating in the real economy rather than solely through financial markets. The three-month annualised pace of M2 growth has recently tested 9.5%. If velocity is unchanged, that money growth should translate into a similar pace of nominal GDP expansion.



The recent *Philadelphia Fed manufacturing survey* provides another near-term gauge of nominal GDP momentum. July data point to stronger activity and elevated prices-paid readings, consistent with an implied 8–9% pace of nominal GDP growth.

Together, the money and survey data indicate that upward pressure is continuing to build in US funding markets.

The Policy Dilemma And Investment Conclusion

Keeping oil prices and bond yields low can support economic activity in the near term. Cheaper energy boosts demand, while lower long-term rates ease financial conditions. The problem is that this stimulus ultimately undermines the policy itself: faster nominal GDP growth encourages higher energy use and increases pressure for yields to rise across the term structure.

The key risk is not simply that oil prices and bond yields are too low today. It is that suppressing them may create the very economic strength that forces them higher tomorrow. Japan's recent experience shows how quickly a suppressed yield structure can break once investors begin demanding a higher risk premium.

The investment conclusion is clear. **The more 10-year yields are held down, the more pressure is transferred to the front end of the curve.** In US fixed-income markets, that pressure is already visible in rising 2-year yields, which are harder to manipulate. The Fed may eventually be forced to recognise this pressure and raise policy rates, pulling the entire yield structure higher.

Investors should hedge against the *failure of suppression*: own real assets and energy exposure, reduce vulnerability to rising long-term yields, and avoid portfolios that depend too heavily on permanently cheap oil and artificially low discount rates.

In short, prepare for volatility and **closely watch the front end of the yield curve**: rising 2-year yields are an early signal that pressure is escaping from the long end into higher policy-rate expectations.