A NICE DOSE OF "DON'T FIGHT THE FED"

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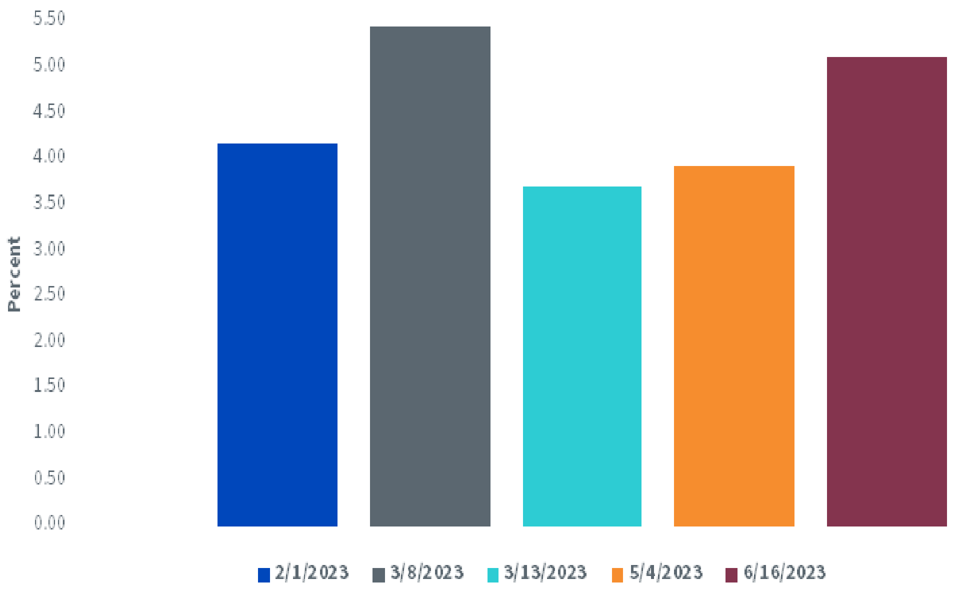
Throughout this Fed rate hike cycle, there always seemed to be some sort of disconnect between what the policy makers were saying and what the money and bond markets were thinking. At various times, you got the sense it was a case of either "don't fight the tape" or "don't fight the Fed." Based upon recent developments in the Fed Funds Futures arena and the U.S. Treasury (UST), it's increasingly looking like a "sea change" in sentiment has occurred where "don't fight the Fed" is now winning out.

Let's first take a look at Fed Funds Rate expectations for the remainder of 2023 now that we're in a post-June FOMC world. It has been truly remarkable to see how these expectations have shifted in just a very short time. Literally the day after the May Fed gathering, the implied Fed Funds Rate for January 2024 stood at 3.93%, or close to the lows that were being posted in the immediate aftermath of the regional banking fears around mid-March. As of this writing, the implied level has soared to 5.12%, or the mid-point of the current Fed Funds trading range, an incredible turnaround of nearly 120 basis points (bps). Essentially, the market went from pricing in more than 100 bps worth of rate cuts by the beginning of next year to a scenario of only one cut, "tops," and that's assuming the Fed raises rates one more time this year.

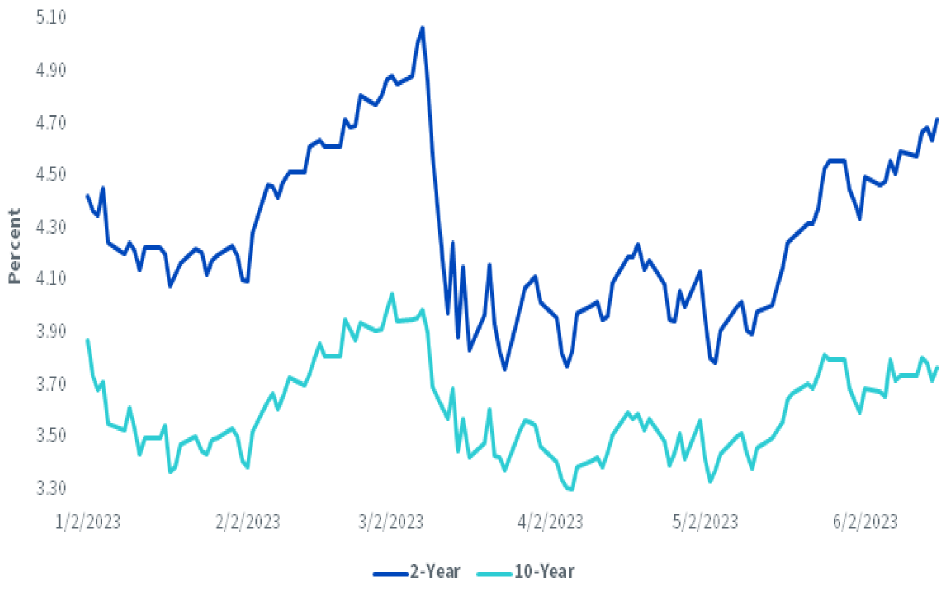
Implied Fed Funds Rates - Jan 2024



Source: Bloomberg, as of 6/16/23.

Needless to say, this shifting Fed rate outlook has also had a rather visible impact on UST yields. In terms of the widely followed 10-Year note, the yield has risen to just under 3.80% as I write this blog post, or about 45 bps from its low point in early May. While this is certainly a noteworthy increase, the spike in the UST 2-Year note yield has been twice this amount over the last month or so. To provide perspective, the 2-Year yield has risen almost 95 bps and is trading around the 4.75% threshold. While the UST 2-Year yield has not made it back to its pre-regional-banking turmoil high watermark of 5.07%, this recent move may still have more upside, given the shifting Fed rate outlook (see graph).

U.S. Treasury Yields



Source: Bloomberg, as of 6/16/23.

Conclusion

It's fascinating to see that as we move into full summer mode, you don't hear much, if any, talk about rate cuts. What was at one point supposed to be a time when the Fed was going to begin pivoting toward rate cuts, the discussion has now changed to whether Powell & Co. will implement one or two rate increases before this hiking cycle is over. As we've seen time and time again, monetary policy dynamics in the money and bond markets can change quickly and in a very notable fashion, which keeps elevated volatility in play for the fixed income investor.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Bond market : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

Basis point : 1/100th of 1 percent.

Volatility : A measure of the dispersion of actual returns around a particular average level.