WILL POWELL PLAY “FED TEXAS HOLD’EM”?

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As I mentioned in last week’s blog post, it seems as if the money and bond markets have turned the page to 2023 when determining the outlook for the Fed. However, three FOMC meetings are left this calendar year, and policy makers are making it abundantly clear that they have more work to do on the rate hike front. For the markets, the question for next year has apparently shifted to rate cuts rather than additional rate hikes. But could there be another option—that is, the Fed stays “on hold”?

There appear to be two schools of thought regarding the Fed Funds outlook within the halls of the Eccles Building, the Washington, D.C., home of the Federal Reserve. Perhaps the more headline-worthy comes from the camp of St. Louis Fed President James Bullard. There is no doubt Bullard has been one of the more hawkish voting members this year, emphasizing the need to front-load rate hikes and move aggressively in the process. Once that goal is attained, the Fed could pivot to rate cuts later in 2023.

The other camp can be best described as the “raise and hold” crowd. This line of reasoning agrees with the front-loading approach and moving the Fed Funds target range into restrictive territory. However, the main difference is that rate hikes would not be aggressive to the point that they would have to be reversed in relatively short order. Rather, once Fed Funds reach a level deemed acceptable to tamp down inflation, the Fed would go on hold, with the target range staying put for a while, perhaps for all of 2023.

So which camp do the money and bond markets espouse? The hike-and-cut one. Indeed, Fed Funds Futures continue to point toward a peak in rates occurring around Q1 or so of next year, followed by rate cuts transpiring somewhere around or shortly after midyear 2023. It should be noted that the amount and degree of rate cuts have been pared back a bit post-jobs report, but they look to decrease nevertheless.

With respect to the Treasury (UST) market, the recent notable inversion of the 2s/10s yield curve is indicative of the hike-and-cut camp as well. Shorter-dated yields, such as the UST 2-Year note, need to discount the prospects for additional rate hikes for later this year and maybe early 2023, while the 10-Year yield reflects the notion that a recessionary economy will force the Fed to cut rates.

The September 21 FOMC meeting is still a long way away. While Federal Reserve Chair Jerome Powell stated the Fed would offer less “clear guidance” on rate moves going forward, it will be interesting to see if he weighs in on this debate at the upcoming Jackson Hole, Wyoming, conference or sooner.

Conclusion

The bottom-line message is that rate hikes are still coming and that yield curves will be flat or inverted going forward. Against this backdrop, investors should consider keeping a shorter duration profile in their fixed income portfolios.

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DEFINITIONS

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

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

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.

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

Federal Funds (Fed Funds) : Excess reserves that commercial banks and other financial institutions deposit at regional Federal Reserve banks

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

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.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Inverted Yield Curve : An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.