FED WATCH: "EXIT STAGE LEFT"

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Another FOMC meeting is now "in the books," as the policy makers just completed its September convocation. For those keeping track, that leaves two more Federal Reserve (Fed) meetings this calendar year. Once again, from a broader perspective, there were no official changes announced following today's meeting regarding the Fed Funds Rate and its quantitative ease (QE) program. That being said, the Fed has seemingly moved on to the next phase of its exit strategy and appears to be setting the stage to begin tapering its balance sheet by year-end.

The movement to prepare the markets for the taper process has, thus far, gone rather well. Indeed, as compared to the 2013 "taper tantrum," there has not been any meaningful negative bond market reaction as a result of the Fed's forward guidance. So, kudos to Powell & Co. on that front.

Now the tricky part begins…providing forward guidance for "liftoff," aka the first rate hike. This part of the Fed's exit strategy has the potential to create a setting of heightened volatility for the money and bond markets.

The policy makers had outlined the criteria that needed to be met for both tapering and the first rate hike: "substantial further progress" toward its inflation (price stability) and maximum employment goals. Chairman Powell reiterated at Jackson Hole last month that this "test" has been met on the inflation front but more evidence is needed on the jobs front, a point the Fed still seems to be aligned with. In other words, the inflation goal is sufficient to begin tapering, while the maximum employment goal still needs more progress to consider any rate hikes.

That brings us to the Fed's Summary of Economic Projections (SEP). The September meeting fell into the policy makers' calendar of SEP updates—more specifically, its "blue dots" (the Fed's own forecasts for Fed Funds over the next few years). These forecasts have shifted quite noticeably throughout the year. Prior to June, the Fed's own projections were for no rate hikes through 2023, but this position changed at that mid-year meeting when 2023 became the "new" estimate, and 2022 was not too far behind.

Well, now the Fed's 'blue dots' reveal an evenly split forecast for lift-off occurring in 2022 and 2023. In fact, three members actually estimated two rate hikes for next year. While there is a long way to go between now and the end of next year, this "pushing forward" of the timing for liftoff is a noteworthy development. Up to this point, Powell has not been as 'hawkish' on the rate front and has tried to de-link tapering from rate hikes. In my opinion, the Chair will pursue a cautious approach and let the data dictate his next move. That's why future jobs reports will be an integral part of the decision-making process.

Conclusion

The U.S. Treasury (UST) market now has a new, and arguably very important, consideration to factor into the valuation process. Up to now, Fed rate hikes have not been part of the mix, but that has clearly changed. While the lion's share of the headlines focuses on the UST 10-Year yield, I suggest keeping an eye on the "whole curve," especially to see how shorter-dated maturities react to the Fed's future forward guidance on rate hikes in the months ahead.

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DEFINITIONS

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

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

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

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.

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

Inflation : Characterized by rising price levels.

Blue dots : the midpoint target range/level of the FOMC participants' projections for the future Federal Funds Rate.

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

Maturity : The amount of time until a loan is repai.