# ARE THE WINDS OF CHANGE TURNING INTO GALE WARNINGS?

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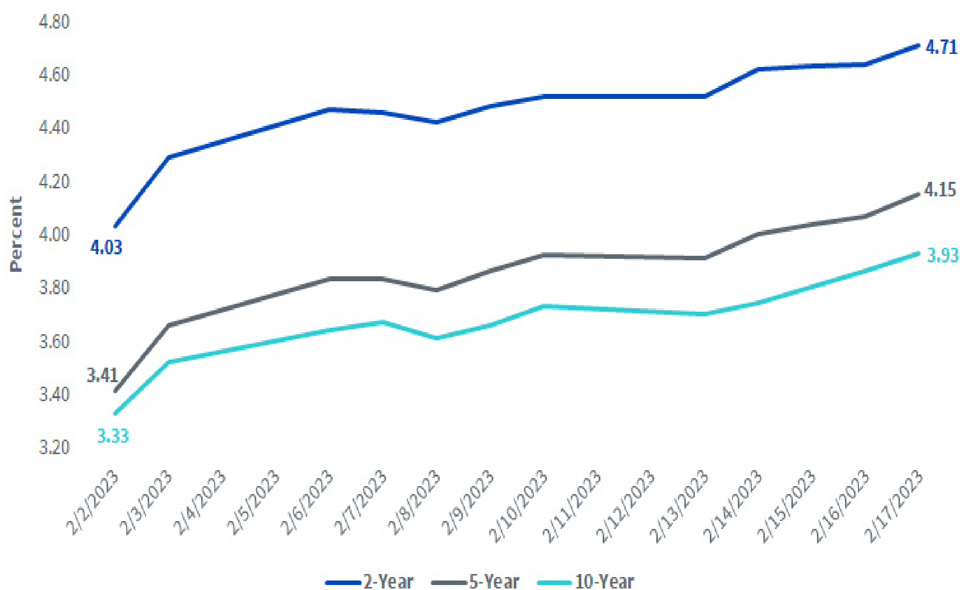
With calendar year 2023 barely more than six weeks old, volatility in the money and bond markets has taken center stage. For the U.S. Treasury (UST) market, January (and the first two days of February) could be characterized as a full year's rally occurring in only about one month's timeframe. However, over the just completed fortnight (that's two weeks, so you don't have to Google it), UST yields have completely reversed course, as the market's narrative has changed dramatically.

This "fortnight" timeframe is what I wanted to go a little bit deeper on. The aforementioned rally to begin the year had its genesis in the notion that the economy would more than likely show signs of heading into recession territory, while at the same time, inflation would continue on its recent "cooling" path, bringing with it increasing talk that disinflation was now the new trend. Of course, these two outlooks don't happen in a vacuum. In other words, Fed rate hikes would soon be coming to an end, ushering in the next phase of monetary policy, rate cuts, happening sooner rather than later.

**U.S. Treasury Yields**




Source: Bloomberg, as of 2/17/23. Past performance is not indicative of future results.

So, what happened? A blockbuster jobs report, to begin with. The completely unexpected surge of more than a half-million new jobs being created in January, combined with the lowest unemployment rate since 1969, represented a direct challenge to the "inevitable recession" narrative. The very solid jobs data was then followed by back-to-back "hotter" than anticipated inflation readings. While declines in year-over-year readings for both CPI and PPI were registered, the actual levels themselves were higher than consensus forecasts. As a result, the disinflation thesis "took a hit" as well.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Against this backdrop, the Fed outlook also underwent a rather noticeable shift. The notion of just one more rate hike at the upcoming March FOMC meeting has now been replaced by the prospect of potentially three more 25-basis-point (bp) increases occurring before Powell & Co. go on an extended pause. To provide perspective, on February 2 (the day before the jobs report), the implied probability for Fed Funds Futures had the terminal rate peaking at 4.90%, but as of this writing, the level has increased to just under 5.30%.

Needless to say, the UST market experienced a reversal of fortune, with yield levels rising considerably all along the curve. The UST 2-Year yield actually reached as low as 4.03% on February 2 and has since surged nearly 70 bps to as high as 4.71%, on an intraday trading basis, over the last two weeks. The UST 5-Year yield followed a similar pattern, increasing by nearly 75 bps. Meanwhile, the UST 10-Year was not to be "outdone," as a 60-bp increase brought its yield level to within hailing distance of the 4% threshold (3.93%) as of this writing.

## Conclusion

As I've noted before, this type of heightened volatility should be expected when the Fed and, by extension, the UST market come into full data-dependent mode. We still have a way to go before the next FOMC meeting on March 22. For the record, the policy makers and bond market investors are scheduled to receive one more jobs and CPI report before this convocation. Could the narrative experience another "wind of change"? If the aforementioned data "rolls over," sure, it's possible, but right now, I'm leaning in the direction of it not being probable. In this context, it is entirely within the realm of possibility that Treasury yields could still have more room to move to the upside.

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## DEFINITIONS

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

**Money Market** : a market for highly-liquid assets generally maturing in one year or les.

**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.

**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.

**Treasury yield** : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

**Recession** : two consecutive quarters of negative GDP growth, characterized generally by a slowing economy and higher unemploymen.

**Inflation** : Characterized by rising price levels.

**Disinflation** : Term used to describe instances of slowing inflation, different from deflation in that price levels are still increasing overall, just at a slower rate.

**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.

**Monetary policy** : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

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

**Consumer Price Index (CPI)** : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Producer Price Index** : weighted index of prices measured at the wholesale, or producer level.

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

**Basis point** : 1/100th of 1 percent.