DID THE FED CUT RATES WITHOUT TELLING ANYONE?

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The second half of March was certainly eventful for the U.S. Treasury (UST) market. Coming out of the recent FOMC meeting, the money and bond markets were elated that no more rate hikes appeared to be in the offing for 2019 from the Federal Reserve (Fed), so naturally, the only place to go from there is…rate cuts, right? Looking at Treasury yields now, one could easily come to the conclusion that the Fed already cut rates but forgot to tell anyone.

What exactly do I mean, you may ask? Well, let's take a look at some key Treasury yield levels, both past and present. The first place to start is the UST 2-Year note, as this maturity would have one of the closer correlations to changes in the Fed Funds target. The UST 2-Year yield began March at 2.56% but dropped to 2.20% only a week ago. In what is referred to as the "belly" of the curve, the UST 5-Year note saw its rate fall a full 40 basis points (bps) during this same timeframe, printing a low of 2.16% as of this writing. Finishing off the trifecta, the UST 10-Year yield was not to be left behind—it experienced a decline of 39 bps, to 2.37%.

Hopefully, the picture is becoming increasingly more apparent. The "big 3" Treasury maturities all witnessed yield declines of 40 bps or just below. Doesn't that have the look and feel of a rate cut? I certainly think so.

To quote Austin Powers: "But what does it all mean, Basil?" Quite simply, the Fed didn't have to lift a finger; the UST market did all the heavy lifting for them. While the Fed Funds target remains in the 2.25%–2.50% range, you now have open market yields such as the UST 2- and 5-Year yields priced more for a 2.00%–2.25% target, or a quarter-point rate cut.

What about the UST 10-Year yield? At the levels as of this writing, *all* of the 2018 increase has now been wiped out. If you were Rip Van Winkle (I may be dating myself here…if you don't know the reference, please google it) and went to sleep in December 2017 and just woke up, you'd be asking, "What's the big deal? The 10-Year is essentially unchanged." However, lost in your slumber was the fact that the UST 10-Year rose nearly 90 bps during this time frame, hitting 3.24% as recently as November 8.

Conclusion

The bottom line is that one of the Fed's primary concerns of late—a tightening in financial conditions—has basically been removed. First, we had the bounce-back in equities and credit spreads, but now a whole new dynamic has been added to the equation: a stealth rate cut.

Unless otherwise noted, all data is from Data is Bloomberg, as of March 29, 2019.

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DEFINITIONS

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.

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.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

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

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

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

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

Basis point : 1/100th of 1 percent.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Monetary tightening : A course of action undertaken by the Federal Reserve to constrict spending in an economy that is seen to be growing too quickly or to curb inflation when it is rising too fas.

Credit spread : The portion of a bond’s yield that compensates investors for taking credit risk.