IS FIVE BECOMING THE NEW FOUR?

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Thanks to Powell & Co., the month of November has gotten off to an inauspicious start for the money and bond markets. I recently blogged about Fed Funds and Treasury yields becoming a "four"gone conclusion , and now that these milestones have been met, you have to ask yourself the question: is five becoming the new four?

It all begins with where the terminal rate of the Federal Funds target range is going. At the September FOMC meeting, the Fed's own median estimate placed the level at 4.6%. However, at the November FOMC meeting presser, Chairman Jerome Powell provided an update, stating that "incoming data suggests the September dots should be higher." What, exactly, is higher? Well, if you look at the June 2023 Fed Funds Futures contract, the level was 5.14%, as of this writing. In other words, the market is pricing in a terminal Fed Funds target range of 5%–5.25%.

Fed Funds vs. Treasury Yields

Source: Bloomberg, as of 11/4/2022.

If this is where the Fed is headed in this rate hike cycle, where does that put the key U.S. Treasury (UST) 2-, 5- and 10-Year yields? Typically, these maturities will trade with a 'spread' or yield level over Fed Funds, especially during a tightening backdrop. This is exactly what investors have witnessed in this go-round as well (see graph), and there is nothing to make me to think this trend won't continue until the Fed pivots to a 'pause and cut' monetary policy phase.

Based on Powell's presser, the Fed is guiding the markets for a potential 'higher for longer' Fed Funds scenario, underscored by his comments that rate hikes still have "some ways to go" and it would be "premature to pause," let alone to think of cutting.

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So, let's look to history for some possible guidance for UST yields. The last time the Fed took Fed Funds to 5% or higher was the 2004–2006 rate hike period. At that time, the peak readings for UST 2- and 5-Year yields reached 5.28% and 5.23%, respectively, while the 10-Year topped out at 5.29% in mid-2007.

Conclusion

The aforementioned UST yield levels are not meant to be an outright prediction. There is no doubt the Fed seems to be leaning toward a slower pace of rate hikes, but the terminal rate sure looks like it's going to be headed in the 5% direction. Against this backdrop, history suggests 5% yield handles could be forthcoming for short-term Treasuries, at a minimum, with intermediate maturities such as the 5-Year note not too far behind. At this point, I'm not ready to make that assumption for the UST 10-Year yield (at least not yet), but it does appear as if some renewed elevation moving back into the 4.25%–4.5% trading range (if not a bit higher) is a reasonable scenario.

Stay tuned…things change quickly!

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DEFINITIONS

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.

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

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

Terminal rate : The peak spot where the benchmark interest rate – the federal funds rate – will come to rest before the central bank begins trimming it back.

Fed funds target range : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

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.

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

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.

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.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Fed tightening : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.