TREASURIES AIN'T BUYING WHAT THE FED'S SELLING

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While the outcome of the December FOMC meeting did not offer any big surprises, the U.S. Treasury (UST) market's response has left some feeling a little perplexed. On the surface, the results tilted more "hawkish," if anything, but UST yields have remained little changed in the days immediately following the Fed's final gathering of the year. As a result, one can't help but think the UST market just ain't buying what the Fed's selling.

I've received a ton of questions, like what is behind the UST market's odd response to the Fed meeting. So, I went back for another look to see if I was missing anything, and here's what I came up with:

- The Fed not only raised the Fed Funds target range by 50 basis points (bps) (an outsized increase), but it also signaled more is on the way.
- The FOMC policy statement was essentially unchanged, with the phrase "ongoing increases in the target range will be appropriate…" remaining in the text. There was some thought that this phrase could be "watered down," but it obviously wasn't.
- The policy maker raised its 2023 median estimate for Fed Funds (dot-plot) to 5.1% versus September's figure of 4.6%. It even bumped up the 2024 level to 4.1% from 3.9%.
- While its growth forecast for 2023 was downgraded, the Fed's projection has no recession in 2023.
- Powell's presser emphasized that policy is expected to stay on an extended hold once rate hikes are done, and no rate cuts will be coming until he's confident inflation is moving toward 2%.

Taken together, it would have been reasonable to expect UST yields to rise in this setting, especially for shorter-dated maturities such as the 2-Year note. In fact, in what is perhaps the first time on record, the current UST 2-Year yield is residing below the Fed Funds trading range, at 4.19% versus 4.25%–4.50% (as of this writing), while the Fed is actively considering further rate hikes.

That brings us back to the aforementioned question. In my opinion, it has become increasingly apparent that the UST market does not think the Fed will push Fed Funds to its new 5.1% target. Inflation seems to be cooling, and the expectation is that economic data will soften to the point that Powell will have to change course sooner rather than later. Interestingly, we have seen Powell pivot quickly already this year, just the other way around. In fact, you could certainly make the argument that Treasuries have already factored in a no-growth/recession for next year.

Conclusion

Where does that leave us to end 2022 and begin the new year? In my opinion, labor market data will return to its center-stage role next year and be the key determinant in whether the UST market is correct in its current thinking or whether the Fed actually

does what it is presently stating it will do. I can see a scenario where the jobs numbers don’t soften sufficiently in the opening months of 2023, and the Fed does bring the terminal rate up toward the 5% threshold and goes on an extended pause. Against that backdrop, UST yields would seem to be vulnerable to some upside pressure. However, as Q2 rolls around, the Fed will end its rate hikes, economic data will weaken and a bond market rally could very well follow suit.

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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.

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

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

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

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

Basis point : 1/100th of 1 percent.

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

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

Dot Plot : a chart based on the economic projections of the Federal Reserve board members that illustrates their views on the appropriate pace of policy firming and provides a target range or target level for the federal funds rat.

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.

Inflation : Characterized by rising price levels.

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.