Bond Blog

PGIM FIXED INCOME

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Fed Aims Hard at Soft Landing

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An optimistic tone regarding a soft-economic landing accompanied the beginning of the Fed's rapid advance on the inflation front, fueling a rally in equities, credit spreads, and long-term interest rates. It marks a point where Fed policy entered a second stage - likely with some market consolidation and less volatility - as the Fed funds target catches up with market expectations.

At its FOMC meeting on May 4, 2022, the Fed began the follow-through on its guidance that it intends to move "expeditiously" towards a more neutral policy stance. As was well telegraphed, the Fed hiked 50 bps, bringing the Fed funds rate target to 0.75%-1.0%, with Powell suggesting at his press conference that additional 50 bps hikes are on the table as possibilities for the Fed's next two meetings. The Fed also announced that in June, it will begin the process of shrinking its balance sheet, letting Treasury and MBS securities roll off at a faster pace than during the Fed's previous Quantitative Tightening (QT) cycle in 2017-2019. All of this was in line with expectations and what the Fed had already signaled in published minutes of its meeting last month.

While Powell began his press conference acknowledging currently high inflation and the pain that it can cause, he later noted the uncertainty the Fed faces in terms of where policy will need to land in order to get inflation back under control. The Fed intends to speed towards neutral, but what neutral will turn out to be and how much beyond that the Fed might need to go remain uncertain at this point. While those are not questions for today - the here and now is high inflation, driving the Fed to step up and front-load its tightening - those are expected to become key questions for the Fed later this year. The Fed will be watching how much financial conditions tighten as it lifts the Fed funds rate and launches QT as well as how quickly and to what extent economic activity and inflation respond. Powell noted that, as of yet, the Fed doesn't see strong evidence that an inflation psychology is taking hold, but it doesn't want to take chances that it may.

Coupled with the intended hawkish message on combating inflation, Powell again reiterated that a soft landing remains a very real possibility - i.e., a scenario in which excess demand and attendant inflation are tamped down, but positive economic growth and a healthy labor market remain. While the Fed has a difficult road ahead, we would agree that the base case is likely a soft landing, but with notable tail risks around that. Household and corporate balance sheets in aggregate are in very strong shape, and there are few visible imbalances aside from high inflation. We expect interest sensitive sectors of the economy will likely respond in coming quarters to tighter financial conditions and that companies' pricing power in general will begin dissipating as workers' wage increases continue to lag.

Thus, given the front-loading of Fed rate hikes, coupled with a rapid ramp-up of QT starting in June, we think risks are likely skewed towards a slower pace of Fed rate hikes by the second half of this year. At that point, the Fed will have had more time to assess the effects of headwinds that are already building - e.g. tighter financial conditions; a fiscal roll-back; high energy and food prices against lagging wages; and a slowing global economy. But for the pace of Fed tightening to slow later this year, monthly inflation readings will need to have convincingly peaked by that point. If inflation does not show signs of moderating as expected, we think any "Volcker" moment of more aggressive Fed action would likely not come until late this year or early next year. As Powell noted, though, his view of a Volcker moment is one in which the Fed does the right thing and what is ultimately needed for the long-run health of the economy.

Embarking on the Second Stage

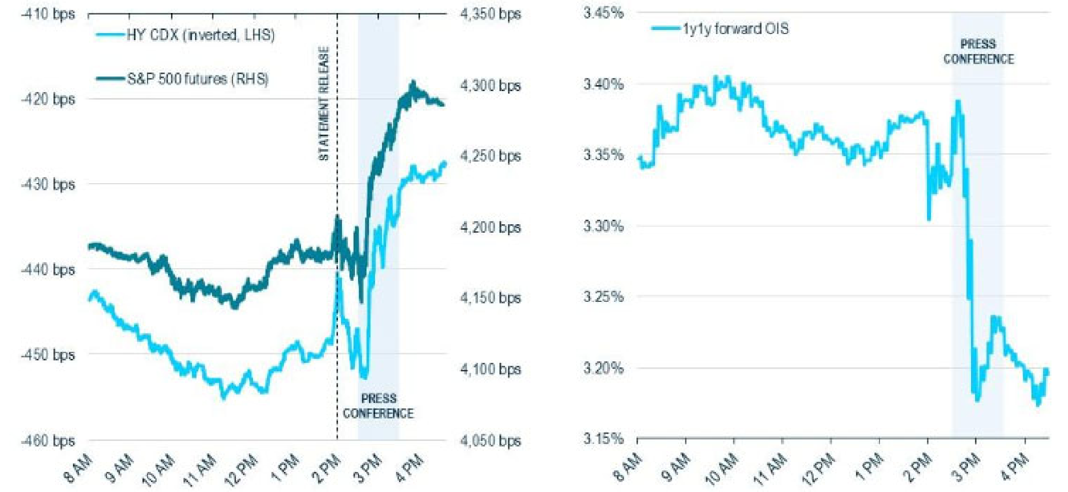
As far as the markets were concerned, the message was clear: the Fed wants to get inflation down to target, shoot for a soft landing, and moderate growth with an appropriate amount of rate hikes. While not presupposing a terminal policy rate, the FOMC has nonetheless made the leap, as in previous meetings, that at least getting to a neutral, mid-2% level will be needed. The markets, on the other hand, came into today's meeting already braced for a peak rate north of 3%.

Today's relief rally in stocks, credit spreads, and most of the Treasury curve (Figures 1 and 2) suggests the market is set to transition from the first stage of the rate-hiking cycle - rates and risk aversion rising as the market braces for hikes - to the second stage where volatility falls as markets consolidate as they wait for the Fed to catch up with market pricing.

FIGURE 1 and 2:

Figure 1: Higher risk assets like corporate bonds and stocks breathed a short-lived sigh of relief after the release of the Fed statement, but then had a large and sustained move higher in price (stocks) and narrower in spreads (corporate credit, high yield cdx as shown in the exhibit) during the press conference, biting down, at least for now, on the fed's "targeting a soft landing" message.

Figure 2: The 1 year 1 year forward OIS swap rate—an indicator of market expectations for the average fed funds rate over the next 12-24 months—dropped sharply as the Chair guided away from 75 bps hikes, instead emphasizing the likelihood of 50 bp moves at the next two meetings in particular.



Source: Bloomberg, PGIM Fixed Income.

Given the Chair's guidance today and the current market pricing, this consolidation phase could easily last through much of the remainder of the year, leaving the rate outlook fairly symmetrical. Looking further ahead, the cycle peak in long-term rates will ultimately depend on just how much tightening is required to bring the economy into balance, which again, as the Chair highlighted today, will be an empirical exercise. As a result, we will remain keenly focused on the incoming data over the days and weeks ahead.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as of May 4, 2022.

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