Bond Blog

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The FED Senses the Light at the End of the Tunnel

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Nearing the end of the Federal Reserve's rate-hiking campaign implies we are now in a fine-tuning phase for monetary policy, in which the decline of volatility shapes the contours of a new bull market cycle.

While it isn't a new message, the main signal from today's Fed meeting is that the end of the hiking cycle is quite close. Chair Powell of course left the door wide open to the possibility of additional hikes - that's the right tactical move to preserve optionality - but we picked up on a couple of important dovish themes that will take on more importance over time.

First, Chair Powell highlighted that although 2% inflation is the ultimate goal, it's not a roadblock to cutting rates. This has been abundantly clear to us thanks to the Fed's Summary of Economic Projections. But Powell placed emphasis on this point today. When asked about a hypothetical scenario in which inflation was stubbornly stuck in the high 2% range, and if that level of inflation would stop the Fed from cutting rates, he emphatically said "I'm not saying that at all."

Our call remains that inflation will continue to recede over the balance of the year (and into 2024). As long as that process continues, the Fed will then need to judge whether the labor market is coming into better balance. And we believe that process has started. In fact, we think labor market conditions will rebalance enough that the first cut is plausible around the turn of the year. At this stage we don't expect a major easing cycle, but rather a "fine tuning" cycle where the Fed lops off 50-75 bps of recent hikes to reduce the restraint on the economy.

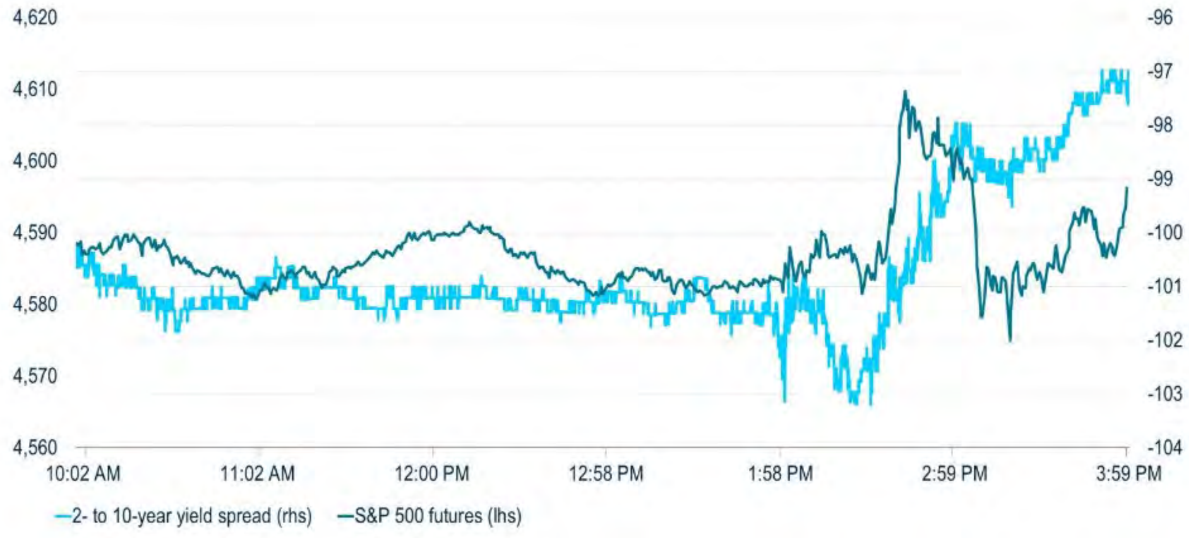
The other idea Powell mentioned, which we emphatically agree with was about real rates. The Fed has now put about 550 bps of nominal tightening into the financial system. In real terms, policy sits at +150 bps, the highest since the Financial Crisis window. And the degree of restrictiveness will only grow as inflation recedes, thus placing even more downward pressure on the economic backdrop at large.

The market will still debate the prospects of more hikes in the coming weeks, and there will likely be twists and turns with each datapoint. Fair enough. We'll get two more inflation and labor reports between now and the September FOMC meeting. So, we have sympathy for the market hedging its bets. But our hunch is the rate hike campaign is now over and that the discussion will turn to rate cuts sooner than many now expect.

Markets Looking for the Light

After leaving off in June on a hawkish note - two hikes expected over the balance of the year - today's statement showed only minimal changes from the June statement, resulting in unusually steady markets during the half hour gap between the meeting's statement release at 2pm and the press conference that followed. While markets continued that stable tone through much of the press conference, a minor spike towards the bullish side occurred about two-thirds of the way through the presser in both rates - a drop in short-term rates in particular - and risk markets, with credit spreads briefly tightening and stocks experiencing a short-lived bounce (Figure 1).

FIGURE 1: On balance, more light than dark. In the wake of the meeting and press conference, stocks ultimately settled marginally higher as the verdict of the rate markets leaned dovish and the yield curve steepened. (lhs: index level; rhs: bps)

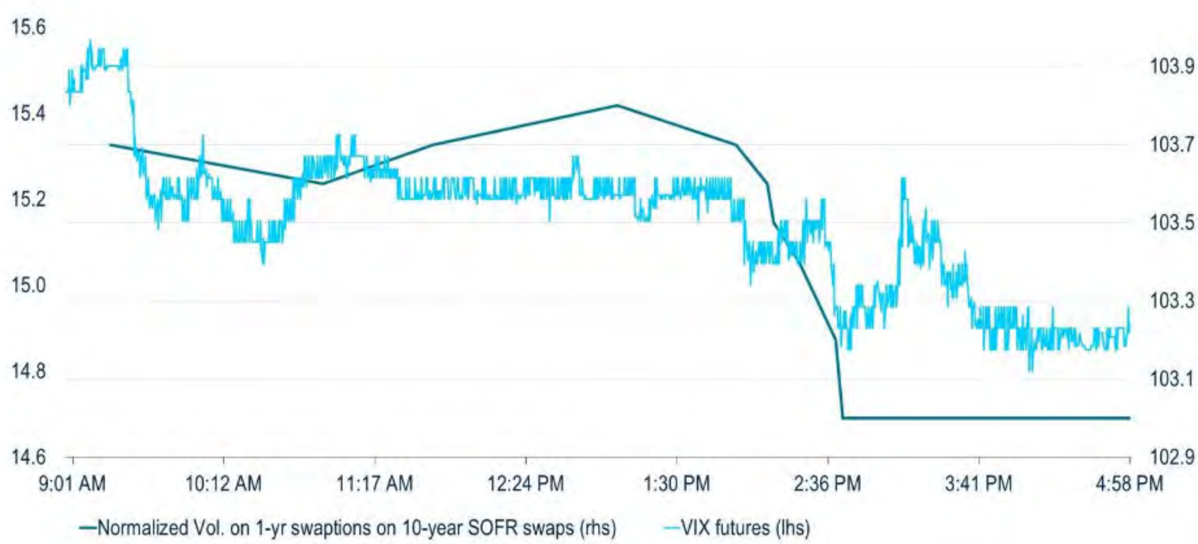


Source: PGIM Fixed Income and Bloomberg.

The impetus appeared to be Chair Powell's clarification that cuts would likely be coming as inflation heads convincingly lower, even before reaching their 2% target.

Critically, measures of volatility edged lower during the meeting, which may be the lynchpin of performance going forward. As the Fed and other central banks' rate of adjustment slows to a near halt, so too will market participants' perceived risk of policy mistakes. This will manifest in less realized volatility across the fixed income markets, which in turn, is likely to support the ongoing search for yield already under way over the last few quarters.

FIGURE 2: Fine tuning the message reduces market anxiety. A clear trend of lower volatility emerged after the Fed's statement release and largely continued through the press conference as markets gained a clearer picture of the Fed's likely path of moderation ahead. (lhs; rhs: index level)



Source: PGIM Fixed Income and Bloomberg.

This reinforces the view that we are in the early quarters of an unusual bull market, one fueled by relatively high and stable yields. While the Fed's achievement of the inflation target will eventually result in lower rates, the twist in this bull market will be the higher returns in the early quarters, simply resulting from the newly regained higher level of income, rather than the typical up and down cycle of recent bull-market cycles.

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as July 26, 2023.
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