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Global Fixed Income Strategy Bulletin

Stagflation nation: FOMC raises Fed Funds rate by 75bps

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<u>Announcement summary:</u>

- At their June meeting, the Federal Open Market Committee (FOMC) raised the Fed Funds Target Rate by 75bps (1.50%-1.75%). While the consensus last week had been a 50bp hike, on Monday various news stories circulated raising the strong possibility of a 75bp hike, so both the futures market and many economists raised their estimates this week to 75bps. This was the first time since 1994 that the FOMC has raised the Fed Funds rate by 75bps.

- Other policy rates such as the IOER (paid to banks for reserves) and the RRP rate (paid to funds for overnight deposits) were also raised to 1.65% and 1.55% respectively.

- The Federal Reserve's "quantitative tightening" program began this month. The Fed did not many additional details on expected balance sheet reduction, other than the cap of $47.5 billion per month stepping up to $95 billion per month by September.

- The "dot plot", or the 18 committee members' current expectation for future rate hikes (it is not a "committee forecast"), was adjusted much higher and now implies almost seven additional rate hikes by the end of 2022 (median 3.40%) and roughly 1 1/2 additional rate hikes in 2023 (median 3.75%). Notably, many participants indicated a slightly higher rate for 2023 of around 4%. 2024 actually shows rate cuts down to 3.375%, and "longer term" the Fed Funds rate actually drops to 2.50% (**Figure 1**). The initial Eurodollar market reaction for 2022 was muted, with the market having already priced eight additional rate hikes in 2022, but 2023 futures eased rate hike expectations slightly (**Figure 2**). **Of note is that the "dot plot" indicates a slightly longer time frame to reach "neutral", and a lower level just below 4%, than what the market had been pricing.**

- The Fed adjusted 2022 projected median Core PCE inflation up from 4.1% to 4.3%, while 2023 was adjusted higher from 2.6% to 2.7%. Risk is to the upside on inflation. Of note, the FOMC repeated its comments that "*inflation remains elevated, reflecting supply and demand imbalances related to the pandemic, higher energy prices, and broader price pressures*." The Committee also referenced the Ukraine conflict again stating that "*the inflation and related events are creating additional upward pressure on inflation*."

- The expected unemployment rate slightly increased from 3.5% to 3.7% for 2022, while real GDP growth actually decreased from 2.8% to 1.7% in 2022 and also decreased from 2.3% to 1.7% for 2023. These are much lower growth forecasts and when combined with the expected uptick in unemployment, suggest that the Fed is signaling their acknowledgment that tightening may lead to slower growth in the future, although in his press conference the Chairman stated that "*there is no sign of a broader slowdown in the economy that I can see*".

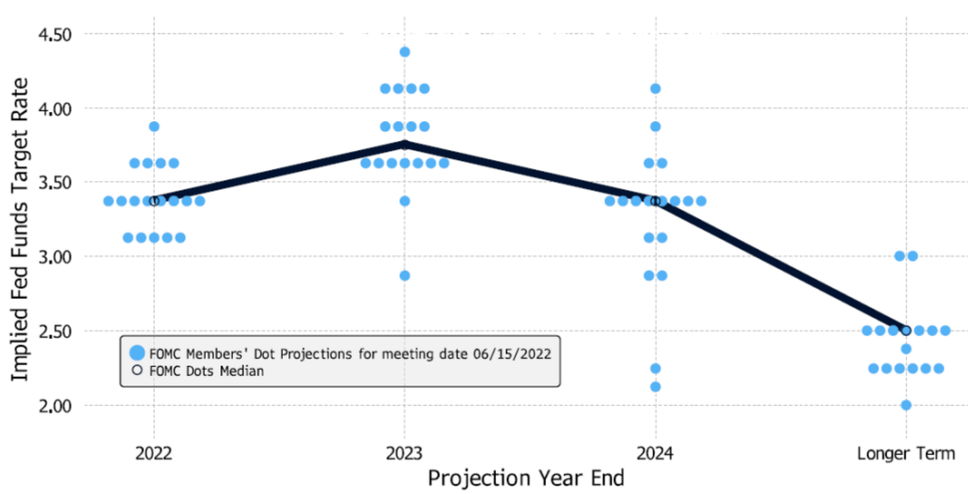
- The FOMC statement also stated that it was "strongly committed to returning inflation to its 2% objective", perhaps to underscore the seriousness of the Fed's commitment in fighting inflation.

- Chairman Powell noted in his press conference after that: "*the pace of rate hikes will depend on incoming data".* Powell also said that a 50 or 75-basis point move was most likely at the next meeting in July, and that he would like to see policy rates "modestly restrictive" at the end of this year at 3-3.5%

- In reference to the 75bp hike the FOMC just made, Powell stated that "*When I offered guidance at the last meeting, I said it was subject to the economy performing about as expected. We got the CPI data and data on inflation expectations late last week and we thought while this is the appropriate thing to do. Do you wait six weeks? That's not where we are. So we decided to go ahead.*"

- Equities and the bond market rallied slightly on both the initial announcement and Powell's press conference. Yields at the front end saw most of the benefit, where the 2y Treasury dropped over 20bps to 3.20%, steepening back out the curve slightly to a 10y yield at 3.37%. The curve still remains quite flat from the 2-30yr, at that 3.20-3.40% area. It's notable however that the longer-end is much closer to the expected 3.75% "neutral rate" that the Fed says it will achieve, suggesting that the pressure on the long-end of the curve may abate for now barring continuing high CPI readings. In that context, we are getting closer to an inverted FF/10yr yield curve, something that in the past 30 years have only happened just prior to recessions. Indeed, given the continued flatness of the curve the 2yr/10yr curve inversion is now a strong possibility, with spreads at only 10bps (**Figure 3**), and while it doesn't have the same accuracy at predicting recessions, such an inversion where it to last would undoubtedly increase market discussion around that possibility.

Figure 1: Fed's median projections for Fed Funds



Source: Bloomberg as of June 15, 2022. Note: Blue line is the FOMC Members' median projection. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion, are subject to change without notice, and are not intended to be a guarantee of future events.

Figure 2: Fed Funds rate by year implied by Eurodollars

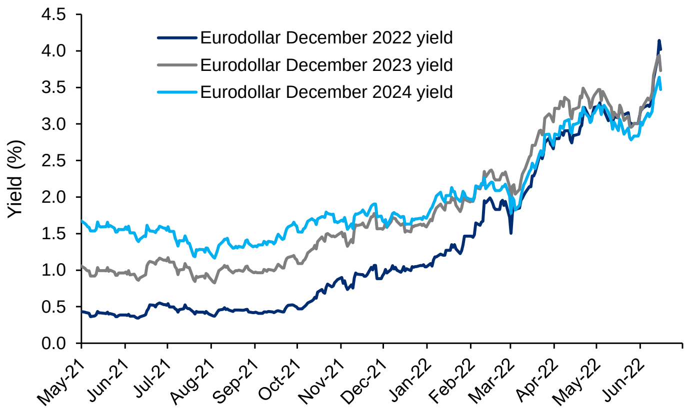


Figure 3: US yield curve, 10yr less 2yr

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Our takeaway:

- Just last year, Chairman Powell noted that lags in the timing of monetary policy's peak impact means that monetary easing or tightening can come at a time after when the need has passed. While we don't believe policy easing should have continued (QE just ended in March), a pro-cyclical US monetary policy is now a risk looking forward given the large buildup of monetary and fiscal restraint.

The FOMC is changing policy at a dizzying rate. After prolonging the largest monetary accommodation experiment through March of this year, and after repeatedly signaling at meeting after meeting a measured pace of monetary tightening (even as they kept accommodating), the Fed today bowed to "the market" and hiked 75bps in a bid to try and regain control of their inflation-fighting mantle. But by raising rates so steeply and quickly, the Fed is risking a sharp economic slowdown, possibly even leading ultimately to a recession in the process (**Figure 4**). Since that first March hike, Fed Funds rates have increased by 150bps – the equivalent of six 25bps rate hikes – and per today's "dot plot" release may rise by possibly almost another 175bps this year to a year-end rate of 3.40%. To put that in context, three months ago at the March 16th meeting the year-end target rate was 1.875% - 1/8th higher than today's new Fed Funds rate – and there were only two committee members who thought the Fed Funds rate needed to move to 3.5% - and that was only by the end of 2023!

What has changed about inflation measures in three months? Actually, very little has changed. Inflation remains elevated and hasn't decreased as quickly as hoped, but it is largely being driven by the same factors it was three months ago: sky-high food and energy prices, supply-chain/workforce imbalances, and shelter price increases. The first factor is in large part being caused by the continuing conflict in Ukraine, the second factor will prove temporary since its primarily logistical and incentive supply imbalances gradually rising to meet "normalized" pre-Covid demand, and the third factor (shelter) is a function of a statistical artifact in how the government calculates shelter price increases with a lag to real-world rent increases. There is little that higher Fed Fund rates – or "tighter financial conditions" (a reduction in financial asset values) – can do to alter demand for food, energy, and shelter, which together make up almost 50% of headline CPI.

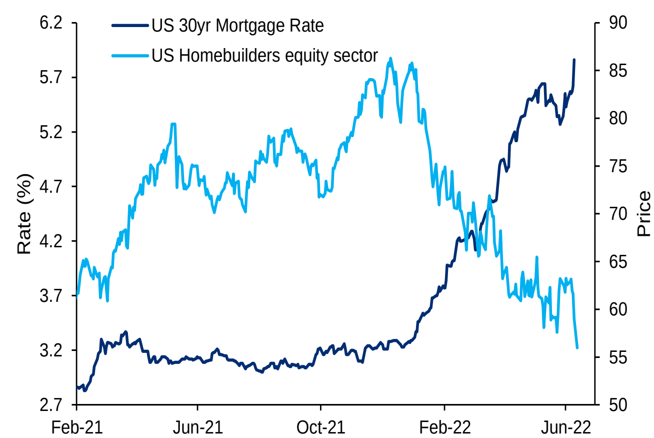
If the economy cools and unemployment rises, then yes there will be reduced aggregate demand as people take fewer vacations, dine out less often, delay non-essential medical services, or wait a little longer for a new appliance or new car. But that reduction in demand is likely only going to have a minimal effect on CPI data, short of a recession. In addition, this drop in demand for discretionary items will only happen over time – the same amount of time when presumably many of the supply chain kinks will be worked out (just as several major retailers recently discovered when they overstocked inventory right when consumer preferences shifted from goods to services). In other words, the surge in demand we are experiencing right now for services may be just that – a surge, and the current demand for hotel rooms and leisure flights may drop just as hotel chains and airlines manage to re-hire enough workers to add supply to meet this recent "re-opening" surge.

So perhaps what changed - and what the Fed may be actually responding to - is the bond market itself, which has been widely seen as "leading"' the Fed in terms of dictating the amount of tightening that will be required to slow inflation. It appears that for now at least, the Fed is willing to follow. However, the Fed's tightening of monetary policy at an accelerating pace – while widely acclaimed by market participants as the right thing to do – may also lead to broad-based "demand destruction". **Indeed, in his press conference, Chairman Powell stated that: "*The role we can play is around demand*."**

However, by raising rates this quickly, while the Fed may achieve its goal of reducing inflation somewhat by pushing down demand**, it may also perversely prolong a higher price environment for longer due to both adding to company costs and leading to firms' underinvestment**. There are several reasons for this. First, the cost of everything that is produced and sold ultimately has to incorporate a higher financing cost. It won't be an immediate adjustment, and many large companies have longer-term fixed liabilities that won't have to adjust in rate anytime soon, but borrowing costs are no different than any other cost-of-goods input. They still have to get paid. So as the Fed raises rates meaningfully, companies will now be trying to figure out how to raise their prices (and/or cut costs elsewhere) so they can absorb these higher financing costs in order to maintain their margins. Second, any new planned CAPEX or expansion project – whether funded by debt or not - will now use the higher "risk-free rate" to price the viability of the investment and will also build in a higher expected financing rate. This will reduce the amount of supply expansion in the economy.

Figure 4: ISM New Orders vs 10yr UST

Figure 5: US mortgage rates & homebuilder stocks



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As a simple example of how higher rates can immediately create a feedback loop where a reduction in additional supply can actually increase CPI, consider the US housing market. US mortgage rates have more than doubled in 12 months from 3% to over 6%, and home sales are falling at a double-digit pace, as are homebuilder equities (**see Figure 5**). The decline in housing affordability is showing evidence of pushing up demand for rent as prospective new homebuyers must rent instead, causing a strengthening in the key core CPI measure of "shelter". With inflation rising twice as fast as wages (**see Figure 6**), the Fed should be asked how a future rise in unemployment would really contribute to price stability. (Labor demand follows consumer spending with a lag, both will weaken on tighter monetary policy).

In addition, while the Fed may be trying to lower demand and therefore prices even if this risks a recession, **this drop in demand may simply result in a corresponding drop in supply.** At the firm-level, unprofitable capacity will be shuttered, resulting in higher unemployment. The consumer discretionary businesses - the primary sector that employs most lower-wage workers and which includes homebuilders – will bear the initial brunt of the "demand destruction" that the Fed is seeking. During the onset of the Covid-19 pandemic, the speed at which retail and other sectors pursued layoffs and other draconian capacity-reduction measures such as closing locations due to the sudden drop in demand was remarkable. We are not suggesting that the Fed's rate hikes will create anywhere near the drop in demand caused by the pandemic, but we do think that businesses will respond to lower demand by reducing their supply, which is ironically a major reason why the economy currently faces higher inflation as some of that lost supply never came back. Reductions in capacity won't be confined to the consumer discretionary industry. Already there are layoffs occurring in "sector adjacent" businesses to homebuilding such as mortgage origination and real estate brokerage. Other sectors such as Technology will likely also be affected, especially new companies that are driving innovation, as their cost-of-capital increases. In addition, in more cyclical industries with higher leverage, pressure will mount to cut costs and focus resources on only the higher-margin activities. Finally, some companies may simply not be able to reconcile higher borrowing costs and lower demand with their business models, and will go out of business, further reducing available supply.

This combination of more ingrained long-lasting cost pressures and declining production is the essence of why stagflation is so pernicious and destructive.

The Fed clearly needed to raise rates and tighten monetary policy, but it would be more prudent in our view to do so more gradually. **Given the Fed's history of easing – and now using QE - in recessions, the Fed should consider a policy tightening trajectory that it can sustain**. Fed Chairman Powell might be more successful leveling with the public by admitting "We can only bring down inflation gradually." Sustaining a gradual tightening would be the best way in our view to slow inflation and not generate unneeded economic instability. Firms and individuals do not have the ability to adjust to such a sharp jump of their financing cost in 9 months, one that raises the potential for long-lasting damage to existing economic relationships.

Yet with the Fed at least now likely committed to this very sharp increase in rates over the next few meetings, and with rates having moved higher in anticipation of these hikes, **we suggest clients use this opportunity to lock in income at the most attractive risk-free base rates in over a decade**. Rates may continue to move higher and create mark-to-market (MTM) losses on fixed income holdings, but the income earned at these existing higher rates will greatly help in offsetting any negative MTM movements, and is now offering in many cases both a positive real return over expected inflation as well the possibility for capital gains opportunities should the Fed's rate hikes ultimately result in a recession and flight-to-quality bid for higher-rated government, corporate, and municipal bonds. In addition, as long as there is no default and the bond is held to maturity, the "MTM loss" represents an "opportunity cost" only – not a cash cost - as the bond ultimately pays back at par.

Figure 6: Real Average Hourly Earnings Y/Y%

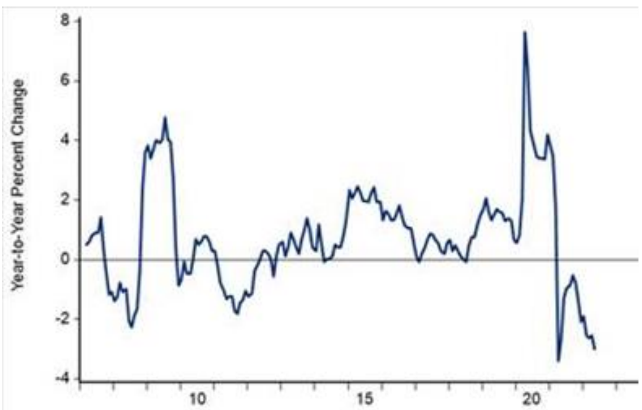
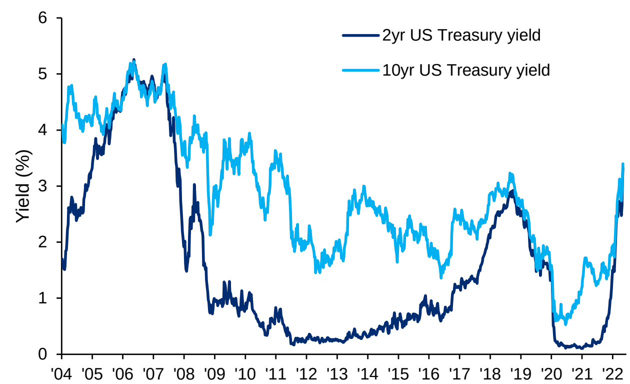


Figure 7: US Treasury nominal yields, by tenor



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Recent U.S. Treasury and credit market comments:

Following the May FOMC meeting, Treasury rates largely paused near the 2.5-3% range waiting to see if CPI would start to cool with the June CPI release. When CPI actually rose slightly, and when another data release on the same day - the University of Michigan consumer survey - indicated 5-10yr inflation expectations hitting new multi-decade highs as well an historic collapse in overall consumer satisfaction, yields shot higher. Prior to today's FOMC announcement, maturities on the yield curve jumped to rates not seen since the 2007/8 period (**Figure 7**). The move was massive – with the 2y adding almost 70bps in three days and the 10y up almost 50bps. The market also quickly repriced the Fed Funds "neutral rate" sharply higher, adding 75bps to a level just over 4% by 2023.

Today when the Fed obligingly followed these market moves with its 75bps rate hike and strong messaging that rate hikes will continue until inflation begins to track lower, there was a relief rally and yields retraced lower some of their spike from earlier in the week. But ultimately with the market and the Fed tracking inflation data, yields will likely remain in a broad range due to the tug-of-war that will be playing out between still-high inflation readings and softer economic data.

"Inflation breakevens" (the required inflation needed to "breakeven" between owning TIPS at current yields vs their nominal Treasury yield counterpart) are the primary real-time financial market indicator we have on future inflation, and while far from perfect, the "direction" of these values at least can often tell us what the market is expecting for inflation. In the near-term, these breakevens remain higher in the short term than nominal Treasury yields, but the difference has shrunk considerably. For example, the 2y breakeven inflation rate has dropped from 5% at the end of March to 4.1%

today, while the 2y nominal yield is up from 2.5% to now almost 3.5%. Longer-term, inflation breakevens are now well below nominal Treasury yields, resulting in a fairly substantial positive real yield of almost 80bps for 10y TIPS, up from negative 64bps just 3 months ago (**Figure 8 and 9**).

However as mentioned above, these higher nominal yields – while perhaps acting to at least brake inflation – are starting to feed into the economy and put stress on borrowers. In credit, investment grade spreads have widened, but only back to their medium-term average. For IG at least, this isn't about deteriorating credit ratios, its likely more about reduced bond market liquidity, increasing downside equity correlation, and achieving absolute yield levels that provide additional compensation over inflation. At nearly 5%, IG index yields now offer substantial compensation over longer-term inflation breakevens for investors (**Figure 10**).

Figure 8: US Treasury Inflation Breakeven Rates (BE)

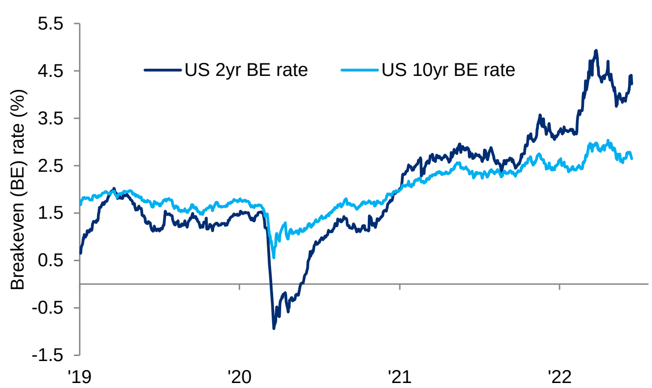

Figure 9: US Treasury nominal and TIPS yields

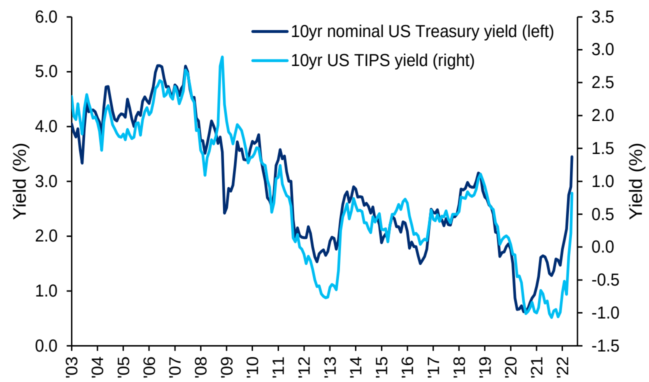

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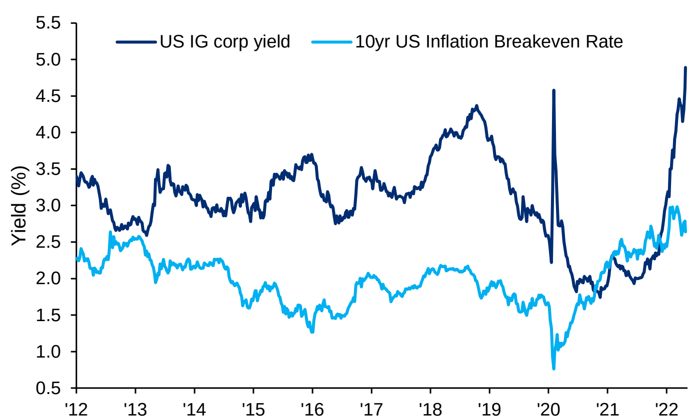
Figure 10: US IG corp vs US BE rate



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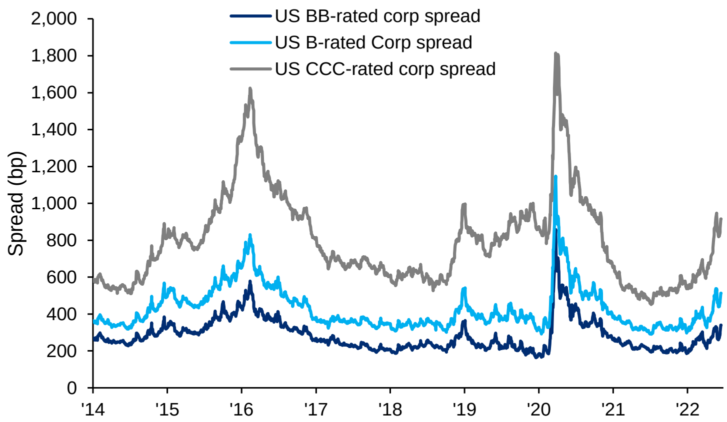
In the high yield space, credit stress is much more apparent, with the HY index spread of 480bps widening close to the 2018 highs of 545bps, which might then threaten to break-out even wider to the late 2015 highs of over 800bps should the Fed not "pause" its rate hike cycle id credit conditions meaningfully deteriorate. At these current levels, some companies appear to be already in some distress given their high spreads, especially in the lower-rated credit tiers such as CCC and even single-Bs (**Figure 11**). Despite these risks, we continue to see value in BB credit, especially among large "fallen angel" companies, even while acknowledging that HY spreads may track wider if the Fed's neutral rate is adjusted higher yet again.

Figure 11: US HY spreads, by credit rating



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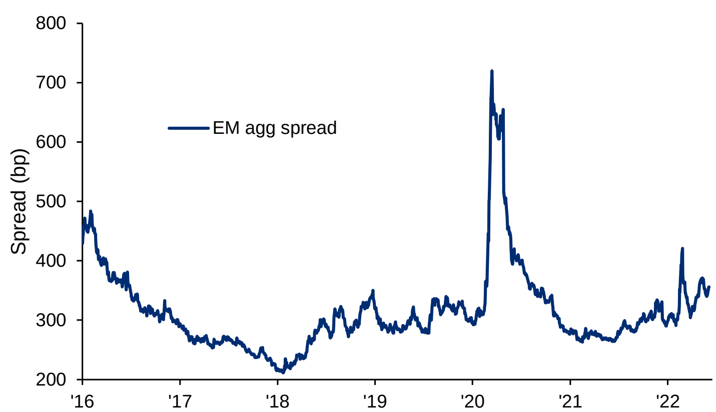
In EM, spreads have widened as well, in sympathy with other credit indexes but also as the US Dollar rises against local currencies. Foreign investors may see more opportunity in USD short-term instruments at these higher yields, leading to more strengthening of the USD and weakening of local currencies. That in turn forces local central banks to keep rates high in order to defend their currency, which can lead to recession in their own countries. While we expect most EM sovereigns and corporates will have no issues with USD bond servicing, if the Fed continues to raise rates than the risk of a "surprise" is increasing. Already, there are some countries such as Turkey which have seen pressure on their currency and USD bond spreads, but again we think these examples will be relatively few within a broad EM index **(Figure 12)**.

Figure 12: EM USD bond spreads



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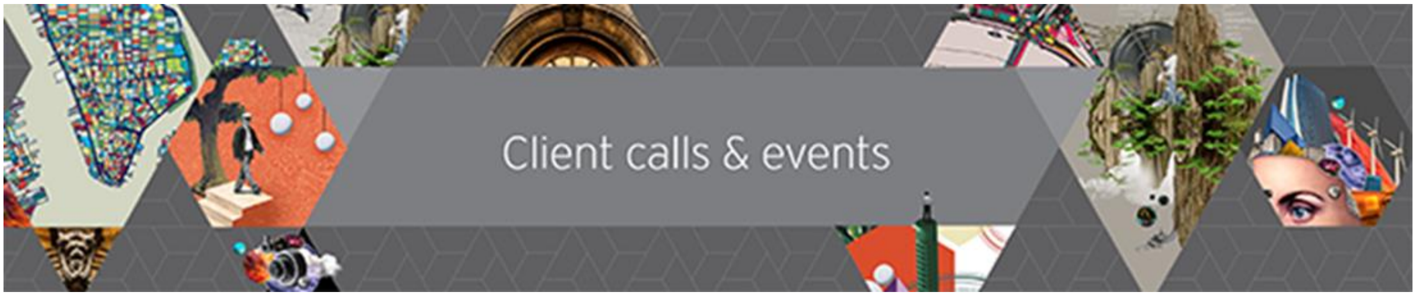
We should note here again, as we have many times before, that dislocations in credit caused by "contagion" are often potential opportunities for investors, and so we continue to suggest some portfolio exposure to credit. We had expected that credit would widen into the Fed's tightening cycle and adjusted our portfolio asset allocation accordingly by remaining underweight in HY, as well as seeking credit hedges. While inflation is expected to remain high in the near term and yields and credit spreads may yet move somewhat higher, in our view investors should consider these higher yields offered by quality credits as an opportunity to obtain longer term core income for their portfolio.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