Citi Global Wealth Investments December 14, 2022

Global Fixed Income Strategy Bulletin

Are we there yet? | FOMC raises Fed Funds rate by 50bps to 4.50%, nearing but not yet arrived at a "sufficiently restrictive" destination

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Announcement summary:

- **At their December meeting, in a unanimous vote the Federal Open Market Committee (FOMC) raised the Fed Funds Target Rate range by 50 bps to 4.25-4.50%, as expected by the market.** With this hike, the Fed's cumulative hikes for 2022 total 425bps. **Critically, the Fed left in language from its November statement that "*ongoing increases in the target range will be appropriate to attain a stance…….that is sufficiently restrictive*."**
- The median average of the "dot plot", or each individual committee member's current expectation for future rate hikes (it is not a "committee forecast"), was adjusted higher yet again and now implies three additional 25bps rate hikes to take Fed Funds to 5.25% in 2023 (upper bound), with the "skew" in dots (representing individual FOMC members) decidedly higher than that (seven committee members were above the median, and only two below it).
  - **This is a 50bp increase in the "terminal rate" versus the September dot plot estimate for 2023.**
- Importantly, the dot plot again does not show any rate cuts in 2023. By the end of 2024 however, the FOMC median dots indicate four additional 25bps rate cuts to 4.25 and four more in 2025 to 3.25%, and thereafter (what the Fed calls "longer term") three more cuts to 2.50% **(Figure 1)**.
  - **This was a "hawkish" dot plot, as the Eurodollar futures had been pricing a terminal rate of 4.8% and a quicker path to rate cuts of 75bps by Jan 24, so it's likely that the Fed wanted to "signal" that rates could both move higher still (to above 5%) and stay elevated for longer (no cuts in 2023).** The Eurodollar market reaction however was initially muted, with only a slight adjustment higher in rate expectations **(Figure 2)**.
- The Federal Reserve's "quantitative tightening" program is now approaching the target cap of $95bn of balance sheet reduction per month, of which $60bn is in Treasuries and $35bn in mortgage-backed securities (MBS). The impact of future reductions on overall market liquidity should start to become clearer in 2023, especially if the economy also enters a recession.
- The Fed adjusted 2023 projected median Core PCE inflation is up from September's estimated 3.1% to 3.6%. Of note, the FOMC repeated its comments yet again that "*inflation remains elevated, reflecting supply and demand*

imbalances related to the pandemic, higher energy prices, and broader price pressures." The FOMC statement also said – as it has many times this year - that it was "*strongly committed to returning inflation to its 2% objective*."

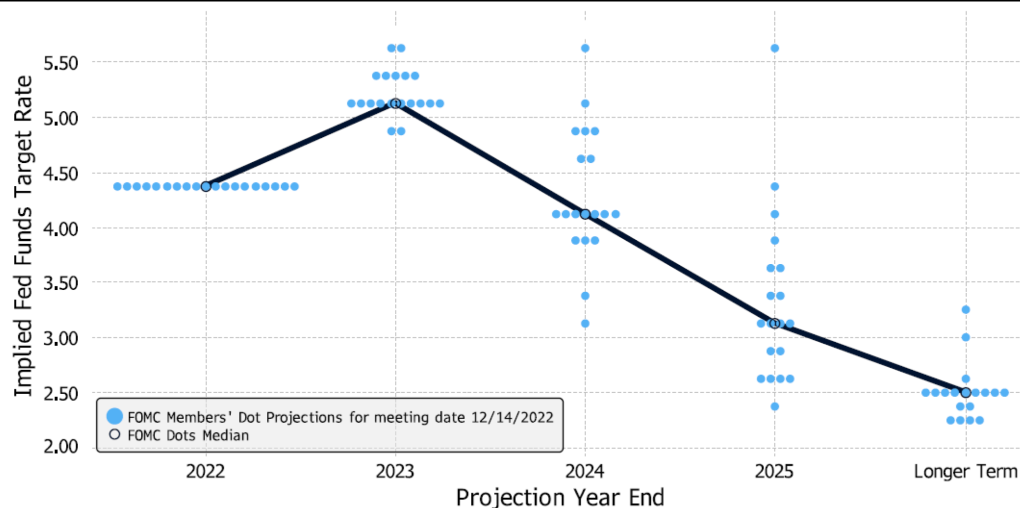
- The projected unemployment rate slightly increased from September's estimated 4.4% to 4.6% for 2023. As inflation is already likely moderating strongly into 2023, **the magnitude of employment losses in the future will likely be the key factor in the Fed's calculus on when it believes it can end its rate-hiking cycle and begin cutting rates.** These projections show more meaningful expected employment loss in 2023, but not overwhelmingly so, which stays internally consistent with the Fed's dot plot of showing that it will try to maintain higher rates for longer.

- The projection for real GDP growth was reduced from September's estimate at 1.2% to 0.5% for 2023. **This is an extremely low growth forecast – almost to the point of expecting a recession – and given the statement and the rest of the SEP forecast, likely indicate that the Fed is willing to endure that if needed**. (Note that Powell explicitly said about this forecast "*I don't think it would qualify as recession*." But it is a very low forecast nevertheless).

- **Chairman Powell noted in his press conference after that: "*The labor market remains extremely tight*" and that wage gains were running well above what would be consistent with 2% inflation. Powell also said that "*We keep increasing that peak rate and we are increasing it again. And inflation risk are to the upside. I can't tell you we won't increase it again.*"** However, Powell also noted that while he had not made a judgement on the size of the February rate hike***, "the appropriate thing to do now is to move at a slower pace and feel our way."***

- Equities and the bond market sold off slightly on both the initial announcement and Powell's press conference, before reversing to see Treasury yields only marginally higher and equities a bit lower. The Treasury yield curve is deeply inverted now, with Fed Funds at 4.50% and the 10yr at 3.53%. This is the most inverted these yields have been since the early 1980s. Historically every time this indicator has been so deeply inverted, a recession has occurred within 6-18 months, and since the curve has been inverted for months now, the likelihood of a recession is increasing per this indicator (**Figure 3**).

Figure 1: Fed's median projections for Fed Funds



Source: Bloomberg as of December 14, 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, implied by Eurodollars

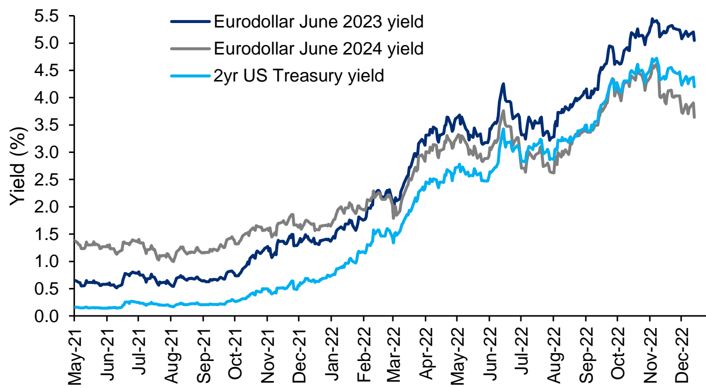
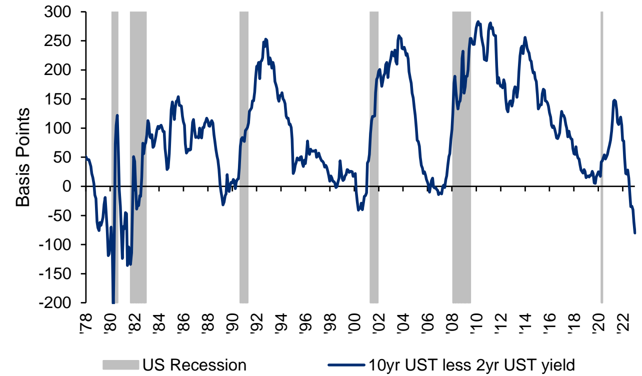


Figure 3: US yield curve, 10yr less 2yr



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Our takeaway:

The Fed shifted its messaging on rate hikes back on 10/21 – even before its November 2nd meeting – by indicating that it would "step-down" rate hikes from its previous pace of 75bps. It followed through on that messaging today with a 50bp hike, so it did indeed "step down".

After the initial communication change on 10/21, bond yields peaked that following Monday the 24th, and ever since that day moved steadily lower (and bond prices higher) for all but the shortest US Treasury maturities such as the 1y (which is anchored around short-term rate hike expectations). The move lower in most yield maturities was staggering, a drop of well over 50bps for the entire curve after 3 years and in some case (like the 10y Treasury) over 70bps (**Figure 4**).

Subsequent Fed communications during this two-month period reinforced the message of a slower pace of rate hikes, but also emphasized that rates would not be cut anytime soon. The market focused entirely on the first part of the message (slower pace of rate hikes) and ignored the second (the Fed will keep rates higher for longer). In fact, not only did the market appear to become more convinced that both "peak rates" were in, but also that the Fed would begin cutting aggressively by the end of 2023 and into 2024.

Figure 4: US Treasury Yield Curve

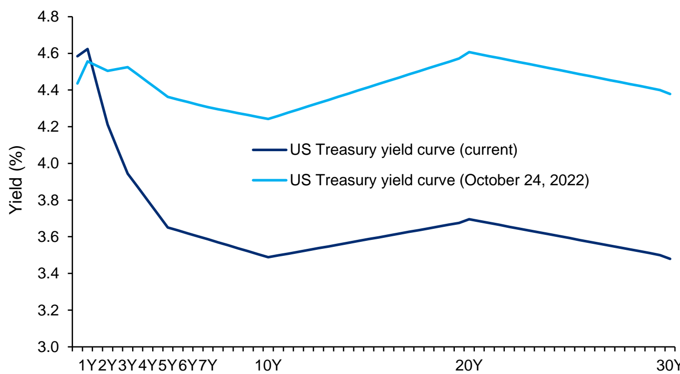
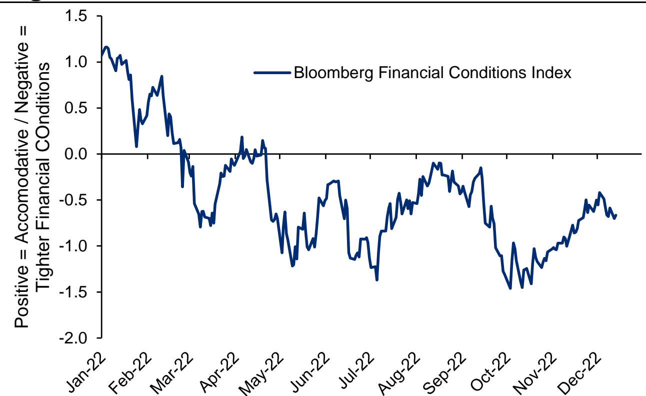


Figure 5: US Financial Conditions



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The move lower in yields last month now appears prescient, albeit with a caveat. The month-on-month core CPI release yesterday of 0.2% - coming after the October release of 0.3% (which was also below expectations) - showed promise that inflation is quickly dropping, but the caveat is that it is only two months of data. **More critically perhaps from the Fed's perspective, "financial conditions" (of which bond yields and mortgage rates are a part) meaningfully eased over**

the past two months (**Figure 5**). They are still restrictive, but much less so than where they were back in mid-October. The Fed likely does not want to see conditions "too tight", but nor do they want them to be "too easy". Looser financing terms and rising equity markets may encourage more spending, which in turn may contribute to maintaining current inflation levels. Every time this year that financial conditions appeared to be moving back to a more moderate stance – in April, early June, and in late August – the Fed has stepped in with increasingly hawkish communication.

Accordingly, while in today's meeting the Fed did reduce its rate-hike pace to "only" 50bps, **the FOMC and Chairman Powell tried to forcefully push back against the narrative that inflation has now receded and so they will soon pause and then cut rates. To a certain degree, they actually indicated the opposite**. The first signal is the dot plot, in which they raised the terminal rate to above 5%, above current market pricing. The second signal is that there is still no rate cut priced in for 2023, which is also well above market pricing. Powell reiterated that they will keep Fed Funds high **until they see inflation rates break meaningfully lower for a meaningful period of time, ie longer than a few months, stating: "*reducing inflation is likely to require a sustained period of below-trend growth and some softening of labor market conditions*"** and "***I would not anticipate rate cuts until inflation is moving down towards 2%% in a sustainable way***".

Over the course of this past year, the Fed has staked all of its credibility on bringing down inflation and then keeping it lower once it reaches the target level of 2% (or closer to 2%). Chairman Powell has stated in the past that he does want to make the mistake of the 1970s, when inflation came in waves over the course of that decade. While they acknowledge that rate hikes act with a lag on the economy, until the economy starts actually showing significant deceleration, it appears that their view is that they cannot simply "pause" and allow more easing of financial conditions (equities moving higher) to undo in part the economic slowing effect they are trying to achieve through higher rates. In his communication of this view, **Powell stated in his press conference that "*financial conditions fluctuate, but important over time they reflect policy restraint*"**

That being said, a few more months of low core CPI might actually result in the Fed pausing, even if this is not what the FOMC and Chairman Powell are indicating now. A decline in inflation combined with increasing recession risks due to the Fed's policy is what markets are likely pricing, as even after the FOMC release today and Powell's commentary, futures markets still only priced about two more rate hikes of 25bps each (to a 5% terminal rate) in January and almost three 25bp cuts in 2023. This is below the new dot plot's 5.25% terminal rate for 2023, and well below the dot plot's expected cuts in 2024. To us, this market pricing indicates that Fed communication as a tightening tool is being increasingly discounted. Perhaps this is because if inflation continues dropping, the market believes it will be difficult for the Fed to communicate why rates need to stay high especially if unemployment starts rising. So, the key for when the Fed will likely "pivot" and actually lower rates will be when unemployment rates head higher.

This is why we continue to discuss the "sequencing" of economic events in our 2023 Outlook (Roadmap to recovery: Portfolios to anticipate opportunities). In our view, once unemployment rates begin durably moving higher, a recession signal might be generated, and the Fed may start cutting rates. Unfortunately, as we have detailed many times before, unemployment rates historically don't start moving higher until the recession has already begun. In fact, in every recession except one dating back to the 1950s, the unemployment rate was at a multi-year low before turning sharply higher (**Figure 6). In other words, we think that despite lower inflation readings, the Fed will maintain high rates until recessionary conditions are apparent, which we expect by the middle of 2023. At that point in time, we believe the Fed will start aggressively cutting rates in order to prevent an even deeper recession.**

Figure 6: US Unemployment Rate

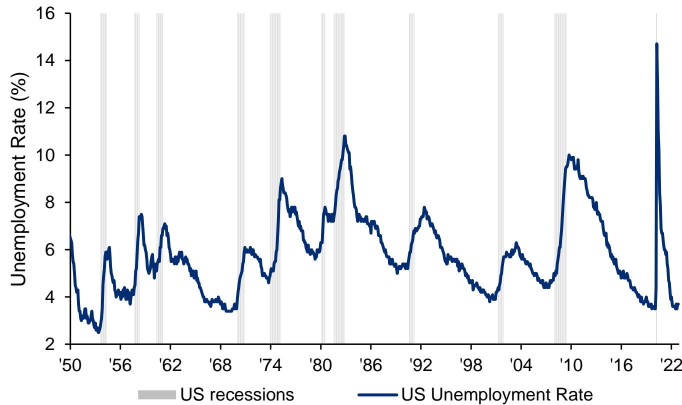
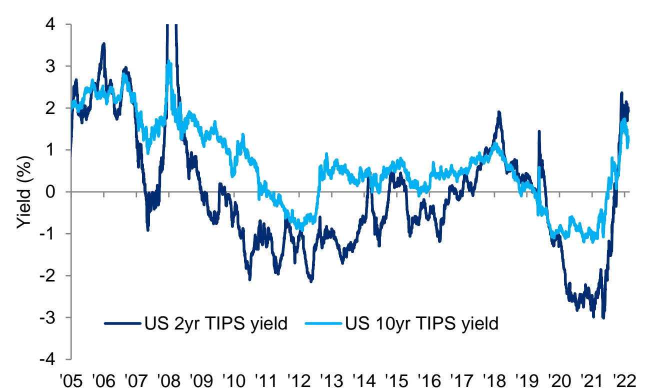


Figure 7: US TIPS yields



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What does this mean for fixed income assets? It's complicated, but again the key is sequencing. First, investors should consider taking advantage of the high short and intermediate-term rates on offer due to the Fed's nearly unprecedented rate-hiking cycle. Treasuries now yield substantially more than expected inflation as measured by Treasury Inflation Protected Securities or TIPS (**Figure 7**). Given our view that the Fed will start cutting rates at some point in 2023, these yields offer a compelling opportunity to consider locking in portfolio income for a few years at least. For investors who want to add even longer-duration Treasuries, we think the market will remain volatile in part due to the Fed's gradual reduction of its balance sheet, so consider looking for opportunities to buy at higher yields.

Second, because of recessionary concerns investors should consider higher credit-quality corporate bonds (or municipal bonds, for tax advantaged investors), as well as selected credits in HY with relatively stronger balance sheets and diversified EM index exposure. There may be opportunities to buy into HY at lower prices if a recession materializes. TIPS may also be an interesting portfolio component given their high real yield, particularly for investors who may think that actual headline consumer price inflation may turn out to be higher than currently priced by these securities' "inflation breakeven", currently below 2.5% for all maturities (**Figure 8**).

Finally, we would suggest that clients look at investment grade rated preferred securities, especially "fixed-to-float" structures which offer yields comparable to high yield credit and which may additionally benefit should the Fed begin cutting rates in the latter half of 2023 (**Figure 9**).

Figure 8: US Treasury Inflation Breakeven (BE) Curve

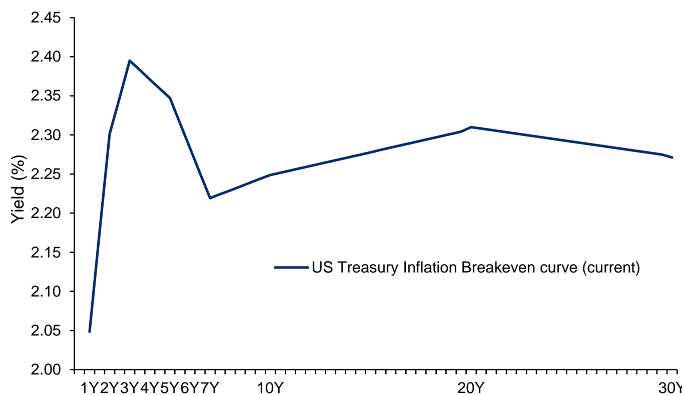
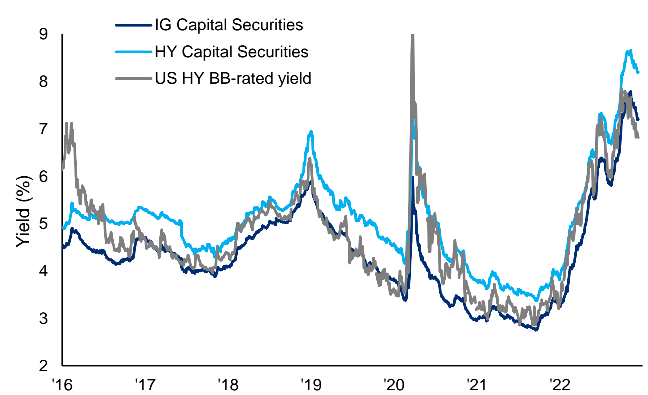


Figure 9: US BB-rated HY vs Preferreds



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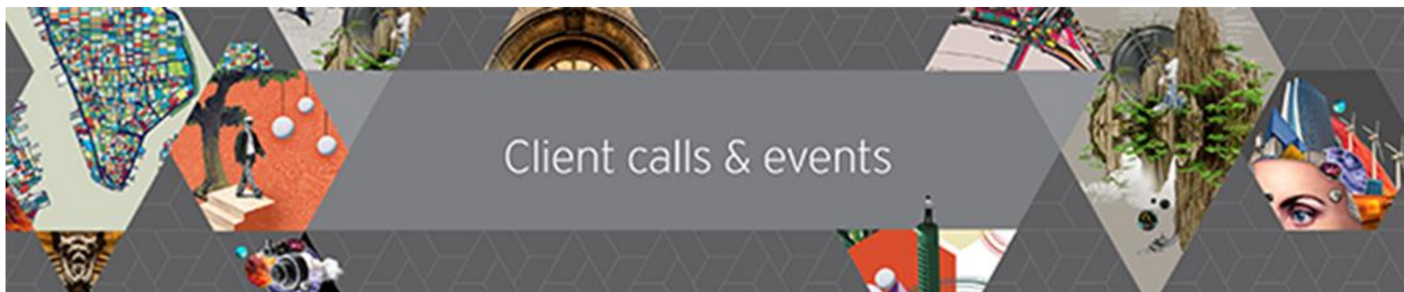

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