A DEEP DIVE ON THE BOND MARKET WITH STRATEGAS

Jeremy Schwartz — Global Chief Investment Officer
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On this week's episode of the *Behind the Markets* podcast, Thomas Tzitzouris, Managing Director and Fixed Income Strategist at Strategas (a Baird Company), joined regular host Jeremy Schwartz, Global CIO at WisdomTree. They discussed:

- How the Federal Reserve (Fed) delivered the most monetary tightening in a single day in the past 30 years between a 50-basis point (bp) rate hike and plans to reduce its balance sheet.
- **Too loose:** Just six-eight weeks ago, Strategas's index of monetary conditions showed monetary policy was the loosest on record and around 400 bps below a neutral stance. Around 40% of that 400-bp gap had been reduced prior to last week's meeting.
- **The Balance sheet will be impactful:** Tzitzouris's team models that $500 billion of balance sheet reduction translates to a 25-bp hike. The Fed has plans to reduce its balance sheet by $3 trillion over the next two to two-and-a-half years or $2 trillion over the next 18 months, which translates to 100 bps of hikes over the next 18 months and 150 bps over 30 months.
- **Main Street vs. Wall Street:** Strategas believes interest rate hikes will impact Main Street more than Wall Street, while the balance sheet reduction will impact Wall Street and corporations. Consumers (two-thirds of the economy) are most sensitive to short-term borrowing costs. When the Fed flattens the curve, large corporations like Apple might see their borrowing costs decline as they become incentivized to borrow to repurchase shares. When the curve steepens, borrowing costs increase and there is less motivation for this activity.
- **Yield curve inversion is not just a leading indicator of a recession, but also causes recessions, in Strategas's view.** This discussion was one of the most interesting segments of the podcast and I encourage listeners to check it out for more details.
- Tzitzouris sees the Fed Funds Rate rising toward 3.25% during this hiking cycle and sees the 10-Year Treasury yield not far from that target. Perhaps the bond market carnage at the 10-year duration will now be slowing down.
- **More pain in TIPS bonds to come:** 10-year real yields had been negative for some time. Those TIPS bonds started getting back into positive territory recently but are still priced well below long-term averages. Tzitzouris believes a 1% real yield on the 10-year bond would be more appropriate on average—and even that 1% rate is below the long-term average yield of these bonds since they were first issued in 1997. Rising real rates would continue to pressure these TIPS bond prices lower, as they have in 2022 thus far.

Given 2022 is the year of macro, rates and inflation as critical variables impacting all markets, this conversation with Strategas is well-timed and worth a listen. You can listen to the full discussion below.

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DEFINITIONS

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

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Basis point : 1/100th of 1 percent.

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.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.

Inverted Yield Curve : An interest rate environment in which long-term debt instruments have a lower yield than short-term debt instruments of the same credit quality.

Federal Funds Rate : The rate that banks that are members of the Federal Reserve system charge on overnight loans to one another. The Federal Open Market Committee sets this rate. Also referred to as the “policy rate” of the U.S. Federal Reserve.

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

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

TIPS : Treasury Inflation Protected Securities.

Inflation : Characterized by rising price levels.