FED WATCH: JUNE GLOOM

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Those of you outside Southern California may not be familiar with the term "June Gloom." It describes a late spring phenomenon where the marine layer brings in cool, cloudy weather in the morning, but the sun peeks through later in the afternoon. I've spent a good amount of time in SoCal, and the surprising rebound in the May jobs report made me think of this analogy. Is the economy about to experience something like this SoCal weather phenomenon? And what does the Federal Reserve (Fed) think?

It was no surprise the Fed left monetary policy right where it is at the June FOMC meeting. Like all of us, the policymakers are in uncharted waters and trying to figure out not only where the U.S. economy is headed in the second half of 2020 and 2021, but also how policy should respond. At this juncture, the FOMC chose the most prudent path of leaving well enough alone. Unprecedented monetary and fiscal policy responses have been, or are about to be, put in place. Let's just wait and see how things evolve.

Thus far, the Fed has to be pleased with the markets' response to its actions. By being proactive and aggressive early on, the Fed looks to have succeeded in avoiding another financial crisis at this point. Indeed, various funding measures are close to being back to pre-COVID-19 levels. In fact, looking at the Fed balance sheet, one can see how it is transforming from phase 1: preventing another financial crisis to phase 2: normalizing the money and bond markets.

Policymakers have already seen progress in phase 2 as well. U.S. investment-grade and high-yield spreads have seen noticeable retracement from their March peak spread readings, while the unusual dislocations seen in the Treasury (UST) market also seemed to have dissipated.

Perhaps more interesting than the June FOMC meeting has been the recent action in the UST 10-Year. The yield level spiked at the end of last week, and at one point was only 5 basis points (bps) away from the 1% threshold. I think the recent trading activity in both the UST and credit markets has underscored my point about the bond market moving on and having already priced in the bad news. Now, the question is more about what 2H2020 and 2021 are going to look like.

Allow me to re-introduce Mr. Fibonacci for some technical analysis: Using a one-year horizon, the next UST 10-Year retracement level is 1.0252%, followed by a 50% retracement at 1.2449%.

Bottom line: As we discovered from the June FOMC meeting, the Fed seems poised to keep the 'pedal to the metal' in terms of its aggressive monetary policy. Against this backdrop, and taking into consideration the recent yield uptick in the UST 10-Year, we suggest investors revisit their fixed income portfolios and consider including some rate hedges.

Stay tuned for next week's blog, where I will discuss some of these specific rate-hedged solutions in more detail…

Unless otherwise stated all data sourced is Bloomberg as of June 5, 2020.

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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.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

Fiscal Policy : Government spending policies that influence macroeconomic conditions. These policies affect tax rates, interest rates and government spending, in an effort to control the economy.

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.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

High Yield Corporate (Bond) : a type of corporate bond that offers a higher rate of interest because of its higher risk of default.

Treasury : Debt obligation issued by the U.S. government with payments of principal and interest backed by the full faith and credit of the U.S. government.

Fibonacci retracement : A technical analysis tool displaying percentage lines which look at support and resistance levels, potentially signaling short-term price/yield reversals. The concept of retracement suggests that after a period of market movement, prices/yields can retrace a portion of their prior pattern before returning to their original trend.