# FED WATCH: IN A HOLDING PATTERN

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For the second meeting in a row, the Fed did what was widely expected and kept the Fed Funds target unchanged at the November FOMC meeting. As a result, the trading range remains at 5.25%–5.50%, still residing at a more than 20-year high watermark. While the policy maker continues to keep its options open for another potential rate hike, as I've said many times before, we are either at or very close to the end of this rate hike cycle.

Against the backdrop of 525 basis points' (bps) worth of rate hikes, the Fed has been presented with an economic backdrop that has proven to be far more resilient than anyone expected, but there is a "new" game in town: potentially tighter financial conditions due to the surge in Treasury (UST) yields, where rates all along the yield curve either hit or came close to hitting that 5% threshold.

Powell & Co. have apparently bought into the notion the aforementioned rise in UST yields may be doing their job for them. However, what I find fascinating is that financial conditions may not have tightened at all. The Chicago Fed's Nati onal Financial Conditions Index has actually fallen (loosened) over the last couple of months. Why is this important? Because this Index is very broad and includes 105 underlying components and would theoretically not be skewed by just one or two factors.

Nevertheless, the Committee seems to have elevated a potential tightening in financial conditions as a monetary policy input. As a result, the question may turn to not whether another rate hike is in the offing, but how long will the Fed be "on hold." And really, when you come right down to it, this is ultimately going to be the key question anyway as we head into 2024 and beyond. With only one more FOMC meeting remaining in this calendar year, the Fed does appear to be united in its stance that rates need to remain in this restrictive territory for the foreseeable future. Hence, the "higher for longer" theme I've been consistently emphasizing.

On that front, as I noted following the September Fed gathering, the expectation for rate cuts has been completely turned on its head. The money and bond markets have gone from discounting the possibility of a rate cut already occurring this summer to now not expecting a decrease in the Fed Funds target until about mid-2024. In addition, as of this writing, the implied probability still has Fed Funds around 4.50% by January 2025!

Whether or not another rate hike is "in the cards," quantitative tightening (QT) continues unabated. The Fed continues on its mission to reduce its holdings of Treasuries and mortgage-backed securities (MBS) on its balance sheet. Although this means a tightening policy has essentially gone under the radar (much like the Fed had hoped), it is a part of the policy maker's toolkit that should not be ignored.

**The Bottom Line**

Regardless of whether the Fed is now officially done or not from a rate hike perspective, the end result of this cycle will be that interest rates are now at levels a generation of investors has not witnessed before, potentially ushering in a rate regimen that harkens back to pre-financial crisis times. Against this backdrop, investors have a whole new dynamic to consider in their fixed income portfolio decision-making process.

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## DEFINITIONS

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

**Fed funds target range** : the interest rate band the Federal Open Market Committee decides to implement for the federal funds rate.

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

**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.

**Basis point** : 1/100th of 1 percent.

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

**Curve** : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

**National Financial Conditions Index (NFCI)** : Provides a comprehensive weekly update on U.S. financial conditions in money markets, debt and equity markets, and the traditional and “shadow” banking systems.

**Fed tightening** : Refers to the Federal Reserve enacting monetary policies that have the overall impact of reducing the availability of credit, which is widely thought to have the potential to slow economic growth.

**Bond market** : The bond market—often called the debt market, fixed-income market, or credit market—is the collective name given to all trades and issues of debt securities. Governments typically issue bonds in order to raise capital to pay down debts or fund infrastructural improvements.

**Quantitative Tightening** : Quantitative easing is a process whereby a central bank targets lowering longer-term interest rates by purchasing bonds and other securities to stimulate the economy. Quantitative tightening is the reverse process whereby securities are either sold or the proceeds of maturing securities are not reinvested with the goal of tightening economic conditions to prevent the economy from overheating.

**Mortgage-backed securities** : Fixed income securities that are composed of multiple underlying mortgages.

**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.