

FED WATCH: PIVOT, PIVOT

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For the third time in a row, the [Federal Reserve](#) did what was widely expected and kept the [Fed Funds target](#) unchanged at the December [FOMC](#) meeting. As a result, the trading range remains at 5.25%–5.50%, still at a more than 20-year high-water mark. For all intents and purposes, it appears as if this [rate hike](#) cycle is now over. However, the tricky part comes now—the pivot for rate cuts.

Interestingly, it doesn't seem as if the Fed is on the same page as the money and [bond markets](#) on the timing and magnitude for potential [rate cuts](#). As we witnessed during the rate hike cycle, especially this year, a disconnect between the policy makers and the markets is not a new development, but this time around, the focus is now on rate cuts, not rate hikes.

Let me provide some perspective. On October 31, the day before the November FOMC meeting, the implied probability for Fed Funds Futures was showing three rate cuts in 2024 worth a total of 75 [basis points \(bps\)](#). As of this writing, the expectation is for five rate cuts totaling 125 bps. Prior to the recently released jobs report it was closer to six rate cuts for 150 bps.

It is still very early in this ball game, and as we have seen many times before, developments can change quickly. One of these developments came in the form of financial conditions. At the prior FOMC meeting, the Fed elevated this as a policy criterion and underscored that the tightening in conditions needed to be taken into consideration and could be akin to another rate hike. Well, a funny thing has happened over the last six weeks. Financial conditions have eased dramatically, to the point where you could be forgiven for wondering if the Fed cut rates without telling anyone. Of course, they didn't, but you get the point.

So, back to the aforementioned "disconnect," and where does that leave Powell & Co.? As 2023 draws to a close, it does not appear as if the Fed is ready to implement rate cuts yet. Sure, that time will more than likely be coming, but I would argue the Fed wants to make sure the [inflation](#) dragon has been slayed before easing [monetary policy](#). The reasoning would be you don't want to cut rates too soon—if somehow inflation doesn't continue to cool, or worse re-ignites, an unintended policy mistake would be difficult to reverse. Now, if the economy, specifically the labor market, "falls off the cliff," then you have a different ball game, but the November jobs report did not validate that line of reasoning.

Also keep in mind [quantitative tightening \(QT\)](#) continues unabated. The Fed continues on its mission to reduce the Treasuries and [mortgage-backed securities \(MBS\)](#) on their [balance sheet](#). Although this type of tightening policy has essentially gone under the radar (much like the Fed had hoped), it is a part of the policy makers' toolkit that should not be ignored.

The Bottom Line

If the Fed is now officially done from a rate hike perspective, the end result of this cycle will be that interest rates are at levels a generation of investors have not witnessed before, ushering in a new rate regime, one that harkens back to pre-global 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.

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.

Rate Cut : A decision by a central bank to reduce its main interest rate, usually to influence rates charged by other financial institution.

Basis point : 1/100th of 1 percent.

Inflation : Characterized by rising price levels.

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.

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.