FED WATCH: TAKING A BACK SEAT, KINDA, SORTA…

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When it comes to Washington, D.C. headlines and the bond market, it's not very often the Federal Reserve (Fed) is not taking center stage. However, with monetary policy seemingly on autopilot, fixed income investors have instead placed their focus on fiscal policy. As a result, one could argue the Fed has now taken a back seat in bond land from an official policy perspective.

I don't want to over-dramatize this point, but it is an important one when it comes to fixed income positioning. First things first—the Fed just concluded its initial FOMC meeting for 2021. In other words, one down, seven more to go. As expected, there really were no surprises at this policy convocation.

As I mentioned before, monetary policy is seemingly on autopilot. What exactly do I mean by that? Well, given the Fed's new policy framework of average inflation targeting, a.k.a. "letting things run hot," any potential rate hikes are apparently off the table this year (let's worry about 2022 a little later on, right?). As a result, the only game in town right now for policymakers is continuing to add to the balance sheet through purchases of Treasuries and mortgage-backed securities (MBS), better known as quantitative easing, or QE.

It is on the QE point that the Fed will have some potential policy flexibility. We've already seen, in the December FOMC minutes and other Fedspeak, some talk about possible QE tapering later this year. However, Chair Powell has made it abundantly clear the Fed is nowhere near making an official policy decision on that front. That being said, if/when the vaccination rollout improves and the economy begins to revert to a more normal, pre-pandemic state, it is certainly in the realm of possibility that we could be talking tapering during the second half of this year. Let's hope so, because that would mean good things on the pandemic front!

Bottom line: So, that leads us right back to the beginning of this blog post—it is fiscal policy that has taken, and will more likely keep, center stage. President Biden has already laid the groundwork with an additional $1.9 trillion proposal that comes on top of December's $900 million stimulus package.

In other words, as we highlighted in our pre-election outlook piece, there are two constants for the bond market in 2021: 1) monetary policy on autopilot, and 2) multi-trillion dollar deficits.

However, as we've seen by the January run-up in the Treasury 10-Year yield, the primary focus is on the potential for reflation, as further unprecedented fiscal policy stimulus in conjunction with extraordinary easy monetary policy can result in higher rates even if the Fed is not leading the party.

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DEFINITIONS

U.S. Treasury Bond : a debt security issued by the United States government.

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.

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.

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

Inflation : Characterized by rising price levels.

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.

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.

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

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

10- Year Treasury : a debt obligation of the U.S. government with an original maturity of ten years.

Reflation : The term is used to describe the first phase of economic recovery after a period of contraction. This period is typically characterized by the act of stimulating the economy through accommodative central bank policies and reducing taxes, to bring growth and inflation back up to the long-term trend.