WHAT A WORLD, WHAT A WORLD

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After last week's (and this morning's) headlines and bond market activity, the only thing that came to mind was that line from the Wizard of Oz. Incredibly, we went from a complete re-pricing of further Fed rate hikes to a setting where safe-haven buying due to concerns surrounding the banking sector took center stage in Treasuries. Let's take a look at recent developments.

- Obviously, the headlines, and attendant money and bond market reactions, are being dominated by news surrounding the impacts of the beleaguered Silicon Valley Bank (SVB) failure
- The Fed has put in place a new facility, the Bank Term Funding Program (BTFP). This funding mechanism offers "loans of up to one year in length to banks, savings associations, credit unions, and other eligible depository institutions pledging U.S. Treasuries, agency debt and mortgage-backed securities, and other qualifying assets as collateral. These assets will be valued at par."
- It is estimated that BTFP could shield banks from $620 billion in paper losses. For some perspective, the original size of the Troubled Assets Relief Program (TARP) was $787 billion
- The implied probability for fed funds has plummeted by more than 150 basis points (bps) for January 2024 since March 8th (Powell's Semiannual Monetary Policy testimony), with essentially no rate hike being expected for next week's FOMC meeting (as of this writing)
- Besides the fed funds rate, the Fed could also turn to their balance sheet and make changes to their quantitative tightening (QT) program if deemed appropriate
- As far as Treasury (UST) yields are concerned, the news on Silicon Valley Bank (SVB) created heightened anxieties about potential stresses in the banking sector and resulted in safe-haven buying, pushing yields dramatically lower
- The UST 2-year yield has plunged 100bps, as of this writing, in just the last three days as flight-to-quality buying and Fed rate cuts are now back to being priced in
- When/If the markets calm down on this front, I would not be surprised to see UST yields reverse course and move back up again

If you're still interested…

- As far as the jobs data, headlines stated it was a "mixed" report, but you need to look at it within the context of last month's blockbuster payroll numbers, i.e., the labor market remains solid notwithstanding the surprising gain in weekly claims last week (they're still low, however)
- From a strictly data perspective, the Fed would normally look at both the Jan and Feb jobs reports in their "totality," and there is nothing there to suggest Powell would have said much, if anything, different last week if he knew what the latest jobs numbers were in advance
- FWIW, I was surprised Powell opened the door to a potential 50bp rate hike for the March FOMC meeting…it just confused the markets and created even more unnecessary volatility
- Prior to the news surrounding SVB, et.al., this week's CPI report would have taken center stage…but arguably, the narrative has now changed considerably

Bottom line: Admittedly, investors may find it difficult to look at the current landscape outside of the prism of the SVB-related headlines. The situation will more than likely be extremely fluid in the days (if not weeks) ahead. From a strictly fundamental perspective, the data were pointing towards ongoing rate hikes and a higher terminal peak level. However, the uncertainty quotient has been heightened, and with it, future Fed policy decisions.

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DEFINITIONS

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.

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

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.

The Bank Term Funding Program (BTFP) : The Bank Term Funding Program (BTFP) was created to support American businesses and households by making additional funding available to eligible depository institutions to help assure banks have the ability to meet the needs of all their depositors.

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

Basis point : 1/100th of 1 percent.

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

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.

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

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Consumer Price Index (CPI) : A measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.