FED WATCH: NIFTY-FIFTY

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In a somewhat anti-climactic fashion, the Fed delivered not only on their widely anticipated 50 basis point (bp) rate hike, but also announced their plans for quantitative tightening (QT) at the May FOMC meeting. With this move, the Federal Funds trading range has now moved up to 0.75%–1%. For the record, this Fed Funds increase was the first half-point rate hike since the May 2000 Fed meeting, 22 years ago.

The money and bond markets will now quickly move on and continue trying to price in what comes next. Heading into the May 2022 gathering, the implied probability for Fed Funds Futures was leaning toward an additional 50 bp increase at each of the next three FOMC meetings. If the policymakers act accordingly, that would mean a total of 225 bps worth of rate hikes will have occurred by the end of September. For 2022 as a whole, Fed Funds have been priced to finish the year in the 2.75%–3% range.

While it makes for good sport trying to determine the magnitude of future Fed rate moves, as I've written over the past few months, the track record for Fed Funds Futures certainly leaves something to be desired. As a result, I would argue that investors should avoid getting bogged down with how many 50-bp moves there may be in the next few months. Ultimately, the Fed is going to get to the same place anyway—it's just a matter of when. Indeed, Powell & Co. have made it clear that their aim is to get to a neutral Fed Funds Rate sooner rather than later and to follow that goal by moving policy into restrictive territory to tame inflation.

Certainly, based on the Fed's rhetoric, another half-point rate hike at the June FOMC meeting will be "on the table," to use Powell's words. After that, the size of the remaining increases could become a bit more data dependent. While the disappointing 1.4% decline for Q1 real GDP did not act as an impediment for the expected tightening in policy at today's meeting, it likely wasn't an outcome the Fed was expecting. That said, rate hikes at the remaining five FOMC meetings in this calendar year and into 2023 remains our base case scenario, which could take the Fed Funds target into the 3%–3.50% range.

And…don't forget QT! While balance sheet drawdown does not capture the lion's share of Fed-related headlines, the FOMC has provided the markets with forward guidance that they will be using this policy tool more aggressively than last time. As I've mentioned before, QT can be viewed in the context of being a quarter point rate hike in and of itself. In addition, QT can impact the entire Treasury (UST) yield curve, not just those maturities that are more closely related to changes in the Fed Funds Rate.

Conclusion

By implementing this two-pronged policy tightening approach, the Fed is taking the bond market into uncharted territory. While Treasury yields have already risen in a visible fashion year-to-date, Powell & Co. have only just begun to put their words into action, keeping rate risk elevated, accordingly. Against this backdrop, we continue to recommend fixed income investors position their portfolios for further increases in interest rates going forward.

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DEFINITIONS

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

Basis point : 1/100th of 1 percent.

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.

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.

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

Fed fund futures : A financial instrument that let's market participants determine the future value of the Federal Funds Rate.

Inflation : Characterized by rising price levels.

Gross domestic product (GDP) : The sum total of all goods and services produced across an 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.

Drawdowns : Periods of sustained negative trends of return.

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