FED WATCH: IS THAT ALL YOU GOT?

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As was widely expected, the Fed kept the Fed Funds Rate target unchanged at the September FOMC meeting. As a result, the trading range remains at 5.25%–5.50%. While the policy makers continue to keep their options open for another potential rate hike before year-end, as I've said many times before, we are either at, or very close to, the end of this rate hike cycle.

When you look at the U.S. economy's resiliency thus far in 2023, given 525 basis points (bps) worth of rate hikes, it begs the question: is that all you got? That is precisely what Powell & Co will be contemplating as we move into the fourth quarter and head toward 2024. Against this backdrop, the Fed's new mantra is to look at the totality of upcoming economic data releases to determine if their job is done.

While the money and bond markets await this data, it is important to remember that even if there are no new additional rate hikes forthcoming, the Fed appears 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, the expectation for rate cuts has been completely turned on its head. As recently as the day after the May FOMC meeting, the implied probability for Fed Funds Futures already had the Fed cutting rates by now. Instead, we got one more rate hike and the markets are still not completely ruling out another increase at the November FOMC gathering. In addition, four months ago, Fed Funds Futures were looking for the target rate to be under the 4% threshold by January of next year. As of this writing, the implied probability still has Fed Funds over 4.50% by the end of 2024! Along the same lines, while the Fed's dot plot garners a great deal of attention as well, as with Fed Funds Futures, investors have witnessed how unreliable these two forecasting tools can be.

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 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

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 have not witnessed before. In addition, the higher for longer theme creates a whole new dynamic to consider in your 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.

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.

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

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.

Interest rates : The rate at which interest is paid by a borrower for the use of money.