Fed Watch: Nifty-Fifty

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In a somewhat anti-climactic fashion, the Federal Reserve (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 Federal Open Market Committee (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 move on quickly 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 bps 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.

Federal Reserve Chair, Jerome 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 Gross Domestic Product (GDP) did not act as an impediment for the expected tightening in policy at yesterday'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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