Bond Blog

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PGIM FIXED INCOME

MARKETS (AND THE FED) GETTING REAL ABOUT TAPER

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Rather than fueling anxiety about QE tapering and higher interest rates, the markets continue to see the Federal Reserve's measured approach to removing monetary policy accommodation as a stabilizing force, likely to protect the economic expansion and stabilize inflation. As a result, we see good prospects for the continued favorable credit market performance as rates and spreads remain relatively range bound around current levels.

As expected, the FOMC voted unanimously to keep policy unchanged at its September meeting, but also teed up a likely announcement on QE tapering at its November meeting, barring any unforeseen shocks that significantly derail the economic recovery. And if all goes according to plan, the Fed should be done tapering by the middle of 2022 - in line with what we've been expecting.

The Fed's updated economic projections were also largely anticipated. With economic activity softening in recent months, expected growth for this year was lowered from 7.0% to 5.9%, while next year's was raised from 3.3% to 3.8%, suggesting some of the current constraints on growth are expected to lift next year.

The inflation outlook for this year was also raised in a recognition of current price pressures, but the Fed continues to expect those inflation pressures to "largely" reflect transitory factors considering its median projections for core PCE decline to 2.3%, 2.2%, and 2.1% in 2022, 2023, and 2024, respectively.

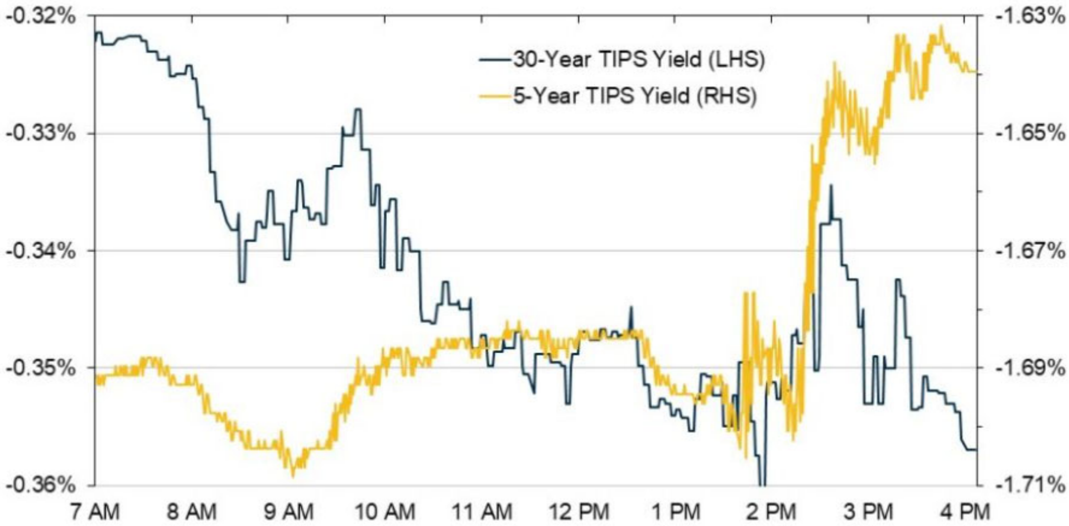
The main surprise was the somewhat more hawkish updates to the Fed's dot plot, with half of Fed officials now projecting at least one rate hike by the end of 2022 and the median Fed funds rate projections for end-2023 and 2024 at a full 1.0% and 1.8%, respectively - modestly higher than what we are currently projecting.

Chair Powell so far has been successful in communicating that tapering plans are separate from the Fed's longer-run plans for rate liftoff and that the Fed intends to complete its tapering before contemplating any rate hikes.

The market reaction was limited, but positive, until Chairman Powell emphasized that the taper could begin as soon as the next meeting. At that point, the realities of the Fed's rising rate projections and imminent taper began to manifest in the market price action, particularly in currencies, inflation breakevens, and Treasury real yields. In terms of currencies, the impact was straightforward with the prospects for higher rates and the closing of the QE spigot (and the associated reduced currency creation) pushing the dollar higher.

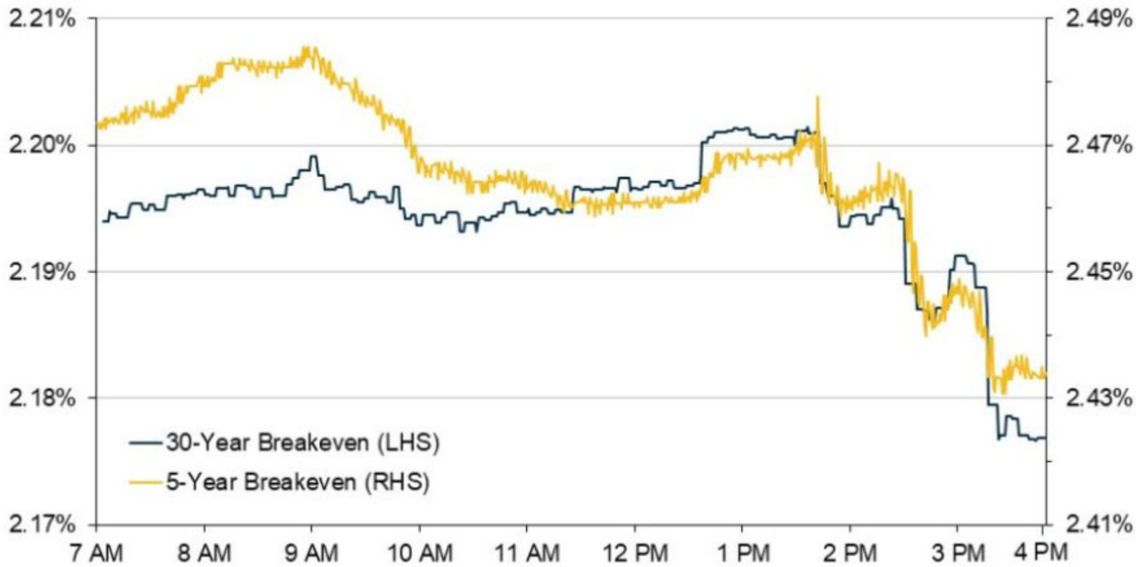
More subtly, but perhaps more importantly, the TIPS market reaction suggested a high degree of confidence in the Fed's ability to achieve a soft landing, while controlling inflation (see Figures 1 and 2).

FIGURE 1: INTRADAY CHANGES IN TREASURY REAL YIELDS – THE BEST WAY TO GET TO THE BOTTOM LINE FOR THE BOND MARKET IS TO LOOK AT EXPECTED INFLATION AND REAL YIELDS AS MEASURED BY TREASURY TIPS YIELDS AND INFLATION BREAKEVENS. INTERMEDIATE TIPS YIELDS ROSE REFLECTING THE FED'S EXPECTED RATE HIKES. HOWEVER, LONG-TERM TIPS YIELDS REMAINED RELATIVELY UNCHANGED, SUGGESTING THAT THE FED'S RATE HIKES WOULD NOT DAMAGE THE ECONOMY'S GROWTH PROSPECTS.



Source: PGIM Fixed Income, Bloomberg.

FIGURE 2: INTRADAY CHANGES IN TIPS-IMPLIED BREAKEVENS – ADDITIONALLY, EXPECTATIONS FOR INFLATION FELL ACROSS THE CURVE FROM ELEVATED LEVELS. BOTTOM LINE: THE MARKET REACTION SUGGESTS THE FED IS IN CONTROL, AHEAD OF THE CURVE, AND WELL POSITIONED TO ENGINEER A SO-CALLED SOFT LANDING.



Source: PGIM Fixed Income, Bloomberg.

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