Bond Blog

PGIM FIXED INCOME

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THE FED THROWS THE GAUNTLET

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At the Federal Reserve's FOMC meeting that ended on January 26, 2022, the Fed signaled that rate lift off is on deck for March - when QE is also slated to end - and that Quantitative Tightening (QT) is in sight for later this year.

After almost two years of aggressive easing, the Fed pivoted late last year from using strong loose-for-long forward policy guidance to now signaling the tightening cycle is poised to begin, but that the policy path will also be much more conditional on growth and inflation conditions from here. On that last point, Chair Powell reiterated the economy is in a very different place compared to the last time it engineered a rate lift off, given current above-trend economic growth, low unemployment, and high inflation. But he emphasized a desire to move policy "steadily" away from extraordinary accommodation to less accommodation. That is, to bring policy in line with the economic recovery - not, at least at this point, to tighten aggressively ahead of a continuing recovery.

The Fed's tightening path this year will be a difficult balancing act given the degree of uncertainty regarding the 2022 economic outlook. The path of the virus, the impact of a fiscal stimulus pullback, the extent of relief in the supply side disruptions, and the potential for geopolitical developments could all complicate Fed policy decisions going forward.

Against this difficult backdrop, though, the Fed will undoubtedly try to avoid overly roiling the financial markets. To this end, the Fed is apparently trying to be as upfront and transparent about its intentions as possible, unexpectedly issuing a statement on the principles it intends to follow in implementing this cycle's QT. Powell stressed the Fed will likely take more meetings to hammer out the details of QT. But the bottom line is the Fed would like QT to be as steady and predictable as possible and for Fed rate hikes to remain the active policy tool.

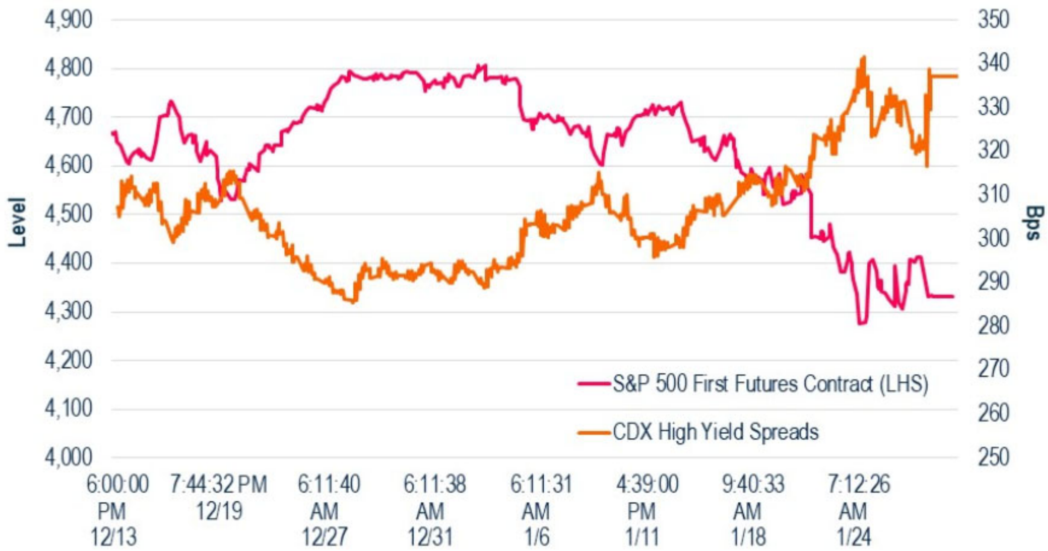
QT in 2022 could appear to be a lot sooner than what the Fed did after the Financial Crisis. But in terms of its tightening cycle, if the Fed indeed begins QT by late summer or early fall as it seems to be signaling, our base case assumes they likely will have hiked the Fed funds rate to around 0.75% or so by that point - only marginally lower than the 1.0%-1.25% Fed funds target range that prevailed when the Fed last launched QT in 2017. And in terms of the economic cycle, Powell stressed the economy is now further along in its recovery.

Our base case still assumes the Fed will wind up hiking rates a total of three times this year and will begin QT at some point in Q3 2022. But if inflation fails to moderate as we expect, Powell provided notice that the Fed is prepared to tighten more aggressively. We think that would most likely entail possible rate hikes at back-to-back meetings, although he did not rule out a possible 50 bp rate hike.

Markets Already Well Braced?

Can the markets survive the Fed's shift in stance? As for the higher risk markets, they were weaker on the day (i.e., credit spreads wider, stock prices lower, see Figure 1), but not worse off than where they were to start the week, suggesting the risk markets may have adequately braced themselves for the tightening ahead and may stabilize now that the Fed has laid out its plans.

FIGURE 1: CDX HIGH YIELD SPREADS AND S&P 500 FIRST FUTURES CONTRACT—WEAKER ON THE DAY, BUT WITHOUT NEW WIDES IN SPREADS OR LOWS IN STOCKS



Source: PGIM Fixed Income and Bloomberg

Furthermore, Powell's indication that the Fed would be flexible in the policy execution - yes, it could become more hawkish, but on the other hand, if inflation and/or growth drops off, it could move to the sidelines - probably resonated favorably with investors. That may seem like a fine point, but in fact, the flexible, humble stance is in stark contrast to the Fed's attitude during the prior hiking cycle when it continued to stress that there was further to go in its tightening cycle - even after the data and markets began to suggest otherwise.

While the Treasury curve bear flattened on the latest developments - with short rates rising to new cycle highs - long-term rates failed to set new highs. Notably, the Fed's shift to the hawkish side has been well received by the long end of the bond market as the 30-year yield remained well below the level set in the Spring of 2021. Additionally, the market's long-term inflation expectations (as measured by 5-year forward 5-year Treasury breakevens), remained relatively unchanged on the day at levels consistent with the Fed delivering on-target inflation over the long run. The stabilization of long-term yields and inflation expectations, as well as the substantial hikes priced into the yield curve, are consistent with our thesis that long term yields are near their peak for the cycle (see Green Light Central Banks, Green Light Bonds).

FIGURE 2: 5Y5Y INFLATION BREAKEVEN, TWO-, 10-, AND 30-YEAR TREASURY YIELDS

Source: PGIM Fixed Income, Bloomberg.

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