Bond Blog

PGIM FIXED INCOME

June 14, 2023

Will the Fed's Policy Bundle Morph into a Bungle ?

Daleep Singh, Chief Global Economist, Head of Global Macroeconomic Research
Robert Tipp, CFA, Chief Investment Strategist, Head of Global Bonds

Although the Federal Reserve's decision to hold monetary policy steady was expected, its arrival carried a set of nuanced ramifications. Indeed, the Fed's combined use of policy tools may fuel one of the very risks it is trying to prevent. Yet, a slowing pace of rate hikes may continue to support credit spreads as long-term Treasury yields drift higher.

The Fed met our expectation for a "hawkish skip," on Wednesday, but with 50 bps of additional policy tightening in 2023 signaled in the Summary of Economic Projections (SEP), the Committee placed more emphasis on the "hawkish" modifier than we anticipated. Ex post, we can interpret the Fed's decision as an attempt to achieve multiple objectives with multiple instruments.

The decision to "skip" a rate hike in June was likely motivated by risk management considerations, namely the desire to buy time to better assess the risk of non-linear damage to the real economy from banking sector stress and tighter credit. Pairing the skip with a hawkish SEP was likely meant to correct any misimpression that today's decision was a definitive pause. In the Fed's base case - and absent the metastasizing of banking sector woes - it is telling us that policy is not yet sufficiently restrictive to bring inflation back to target.

The danger of this policy bundle, of course, is that it becomes a bungle. That is, raising the terminal rate deeper into restrictive territory precipitates the risk scenario ("something breaks") that it's trying to prevent. Put differently, it had a less risky option - instead of raising the expected peak in Fed Funds by 50 bps and reducing the expected end-2024 policy rate by 100 bps, it could have opted for signaling only 25 bps of further hikes this year, but less easing next year.

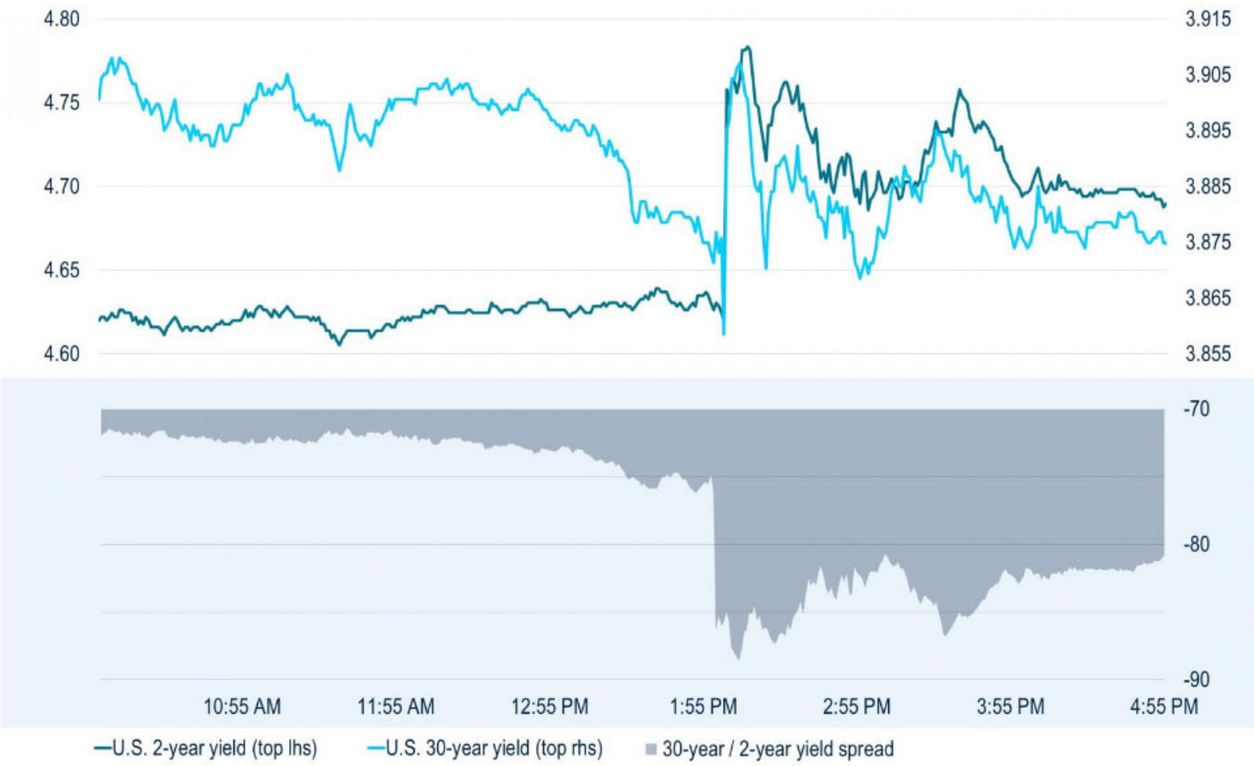
Looking ahead, with 12 of the 18 FOMC participants submitting an expectation for at least 50 bps of further hikes this year, we continue to anticipate a 25 bps hike in July. However, by September, we anticipate that a moderation of inflation pressures will keep the Fed on the sidelines for the balance of the year.

Hawkish (Hold) Surprise to Keep Upward Pressure on Long Rates

The markets took the 50 bps increase in the year-end 2023 "dot" as a hawkish surprise as yields at the front end of the curve moved higher. Increased confidence in the Fed's ability to contain inflation, however, could be seen in the decline in yields at the back end of the curve. Between the rise in short term yields and the decline in long term yields, the 2/30-year curve inverted by an additional 10 bps to negative 83 bps (Figure 1).

Looking ahead, despite today's resilience in the back end of the curve, the combination of a 5%+ Fed funds rate and the Fed's hawkish bias relative to sub-4% yields on longer maturity Treasuries is likely to dampen interest in the back end of the curve, and keep some upward pressure on Treasury yields.

FIGURE 1: The Fingerprint of a Hawkish Surprise: The Yield Curve Breaks with Short Rates Up, Long Rates Down (%; spread in bps)



Source: PGIM Fixed Income and Bloomberg.

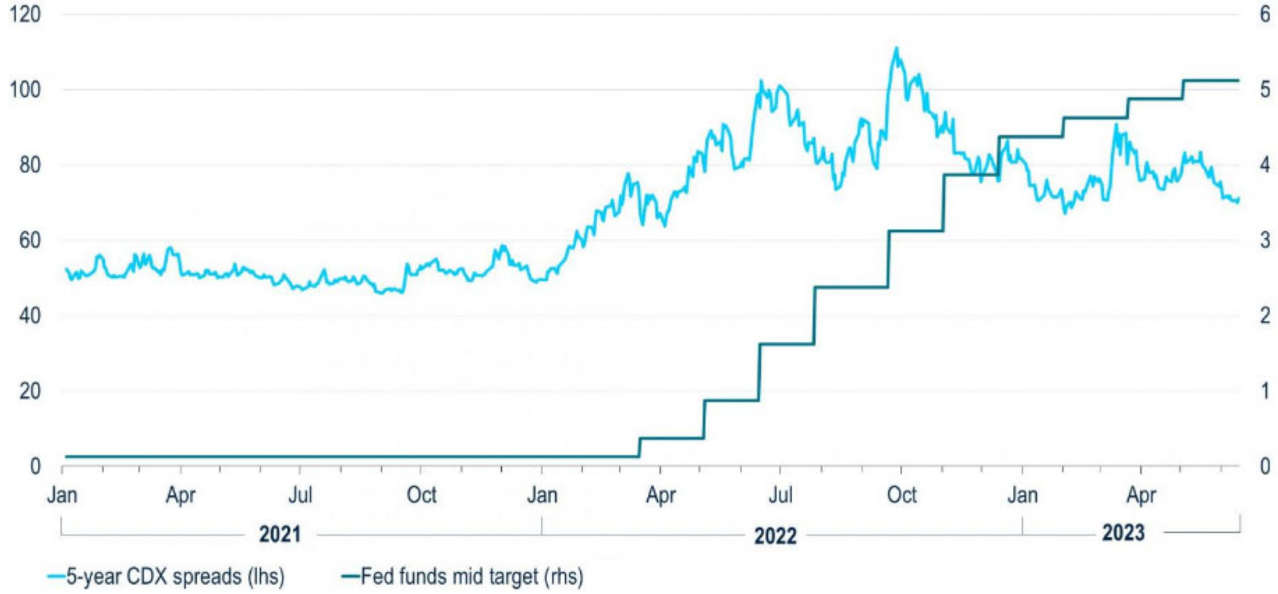
Less Speed + Less Anxiety = More Buoyant Markets?

Risk markets were mixed with stocks falling on the announcement / SEP release before fully recovering during the press conference, while credit spreads widened slightly. From a bigger picture perspective, however, the overall trend in credit spreads has been one of firming since mid-2022 as the Fed's speed of rate hikes moderated (Figure 2). As the pace of rate movements is likely to slow further this year - if not stop altogether - two overriding factors will likely continue to support credit spreads:

1. Increased interest in fixed income at the end of the rate hike cycle, which is already evident in positive retail flows into bond funds; and

2. Decreased odds of a hard landing due to the Fed's more cautious pace of rate hikes.

FIGURE 2: Slowing Rate Hikes Should Continue to Support Spread Products like Corporate Bonds, Structured Products and Emerging Market Debt (LHS in bps; RHS in %)



Source: PGIM Fixed Income and Bloomberg.

Bottom line: As the Fed's rate hike cycle winds down this year, some upward pressure on long rates may be offset by improved risk appetite and credit spread compression, net-net creating a positive environment for the fixed income markets.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of June 14, 2023
For Professional Investors only. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. All investments involve risk, including the possible loss of capital.

Important Information

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. Registration as a registered investment adviser does not imply a certain level or skill or training. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Netherlands B.V., located in Amsterdam; (iii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; (iv) the public fixed income unit within PGIM (Hong Kong) Ltd. located in Hong Kong; and (v) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore ("PGIM Singapore"). PFI of the United States is not affiliated in any manner with Prudential plc, incorporated in the United Kingdom or with Prudential Assurance Company, a subsidiary of M&G plc, incorporated in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary. PGIM Fixed Income as a general matter provides services to qualified institutions, financial intermediaries and institutional investors. Investors seeking information regarding their particular investment needs should contact their own financial professional.

These materials represent the views and opinions of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy.

Any forecasts, estimates and certain information contained herein are based upon proprietary research and should not be interpreted as investment advice, as an offer or solicitation, nor as the purchase or sale of any financial instrument. Forecasts and estimates have certain inherent limitations, and unlike an actual performance record, do not reflect actual trading, liquidity constraints, fee. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.

Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and low interest rate environments increase this risk. Reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Mortgage- and asset-backed securities may be sensitive to changes in interest rates, subject to early repayment risk, and while generally supported by a government, government agency or private guarantor, there is no assurance that the guarantor will meet its obligations. High yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets. Currency rates may fluctuate significantly over short periods of time and may reduce the returns of a portfolio. Commodities contain heightened risk, including market, political, regulatory and natural conditions, and may not be suitable for all investors. Diversification does not ensure against loss.

In the United Kingdom, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority ("FCA") of the United Kingdom (Firm Reference Number 193418). In the European Economic Area ("EEA"), information is issued by PGIM Netherlands B.V., an entity authorised by the Autoriteit Financiële Markten ("AFM") in the Netherlands and operating on the basis of a European passport. In certain EEA countries, information is, where permitted, presented by PGIM Limited in reliance of provisions, exemptions or licenses available to PGIM Limited under temporary permission arrangements following the exit of the United Kingdom from the European Union. These materials are issued by PGIM Limited and/or PGIM Netherlands B.V. to persons who are professional clients as defined under the rules of the FCA and/or to persons who are professional clients as defined in the relevant local implementation of Directive 2014/65/EU (MiFID II). In certain countries in Asia-Pacific, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co. Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is provided by PGIM (Hong Kong) Limited, a regulated entity with the Securities & Futures Commission in Hong Kong to professional investors as defined in Section 1 of Part 1 of Schedule 1 (paragraph (a) to (i) of the Securities and Futures Ordinance (Cap.571). In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the FCA (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws. In Canada, pursuant to the international adviser registration exemption in National Instrument 31-103, PGIM, Inc. is informing you that: (1) PGIM, Inc. is not registered in Canada and is advising you in reliance upon an exemption from the adviser registration requirement under National Instrument 31-103; (2) PGIM, Inc.'s jurisdiction of residence is New Jersey, U.S.A.; (3) there may be difficulty enforcing legal rights against PGIM, Inc. because it is resident outside of Canada and all or substantially all of its assets may be situated outside of Canada; and (4) the name and address of the agent for service of process of PGIM, Inc. in the applicable Provinces of Canada are as follows: in Québec: Borden Ladner Gervais LLP, 1000 de La Gauchetière Street West, Suite 900 Montréal, QC H3B 5H4; in British Columbia: Borden Ladner Gervais LLP, 1200 Waterfront Centre, 200 Burrard Street, Vancouver, BC V7X 1T2; in Ontario: Borden Ladner Gervais LLP, 22 Adelaide Street West, Suite 3400, Toronto, ON M5H 4E3; in Nova Scotia: Cox & Palmer, Q.C., 1100 Purdy's Wharf Tower One, 1959 Upper Water Street, P.O. Box 2380 - Stn Central RPO, Halifax, NS B3J 3E5; in Alberta: Borden Ladner Gervais LLP, 530 Third Avenue S.W., Calgary, AB T2P R3.

2023-4613

留意事項

※本資料はPGIMフィクト・インカムが市場動向に関する情報提供としてプロの投資家向けに作成したものです。PGIMフィクスト・インカムは、米国SECの登録投資顧問会社であるPGIMインクの債券運用部門です。

※本資料は情報提供を目的としたものであり、特定の金融商品の勧誘又は販売を目的としたものではありません。また、本資料に記載された内容等については今後変更されることもあります。

※記載されている市場動向等は現時点での見解であり、これらは今後変更することもあります。また、その結果の確実性を表明するものではなく、将来の市場環境の変動等を保証するものでもありません。

※本資料で言及されている個別銘柄は例示のみを目的とするものであり、特定の個別銘柄への投資を推奨するものではありません。

※本資料に記載されている市場関連データ及び情報等は信頼できると判断した各種情報源から入手したものですが、その情報の正確性、確実性について当社が保証するものではありません。

※本資料に掲載された各インデックスに関する知的財産権及びその他の一切の権利は、各インデックスの開発、算出、公表を行う各社に帰属します。

※過去の運用実績は必ずしも将来の運用成果等を保証するものではありません。

※本資料は法務、会計、税務上のアドバイスあるいは投資推奨等を行うために作成されたものではありません。

※当社による事前承諾なしに、本資料の一部または全部を複製することは堅くお断り致します。

※"Prudential"、"PGIM "、それぞれのロゴおよびロック・シンボルは、プルデンシャル・ファイナンシャル・インクおよびその関連会社のサービスマークであり、多数の国・地域で登録されています。

※PGIMジャパン株式会社は、世界最大級の金融サービス機関プルデンシャル・ファイナンシャルの一員であり、英国プルーデンシャル社とはなんら関係がありません。

PGIMジャパン株式会社
金融商品取引業者 関東財務局長（金商）第392号
加入協会：一般社団法人日本投資顧問業協会、一般社団法人投資信託協会、一般社団法人第二種金融商品取引業協会
PGIMJ99845