The Fed Gazes into a Spinning Compass

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As widely expected, the Federal Reserve raised its policy rate on Wednesday by another 25 basis points to 5.0-5.25% and hinted that its rate hike campaign may have reached its conclusion. However, Fed Chair Powell understandably conveyed some uncertainty given the recent bank failures and shifting economic data. The markets may have run too far ahead of the Fed's cautious stance, leaving long-term rates vulnerable to a moderate increase.

During the press conference, Chair Powell was at pains to emphasize the meeting-by-meeting, data-dependency of the Fed's stance - and that further rate hikes are far more probable than rate cuts. Yet, he acknowledged that the threshold to further tighten policy has risen amid elevated downside growth risks.

Key to this shift in Fed guidance is the lagged and ongoing effect of tighter credit conditions, which are accelerating after the recent shocks to the banking sector. Recall that at the time of this meeting, Chair Powell and his colleagues on the FOMC would have seen the latest snapshot of bank lending conditions from the Senior Loan Officer Opinion Survey, which is one of the more reliable cyclical indicators for inflection points in the economy. Jobless claims provide another key signpost, and, as observed by Chair Powell, the latest readings (along with the March JOLTS data[1]) point to some improvement in the balance between labor supply and demand. Therefore, this improvement may apply less upward pressure on inflation in the pipeline.

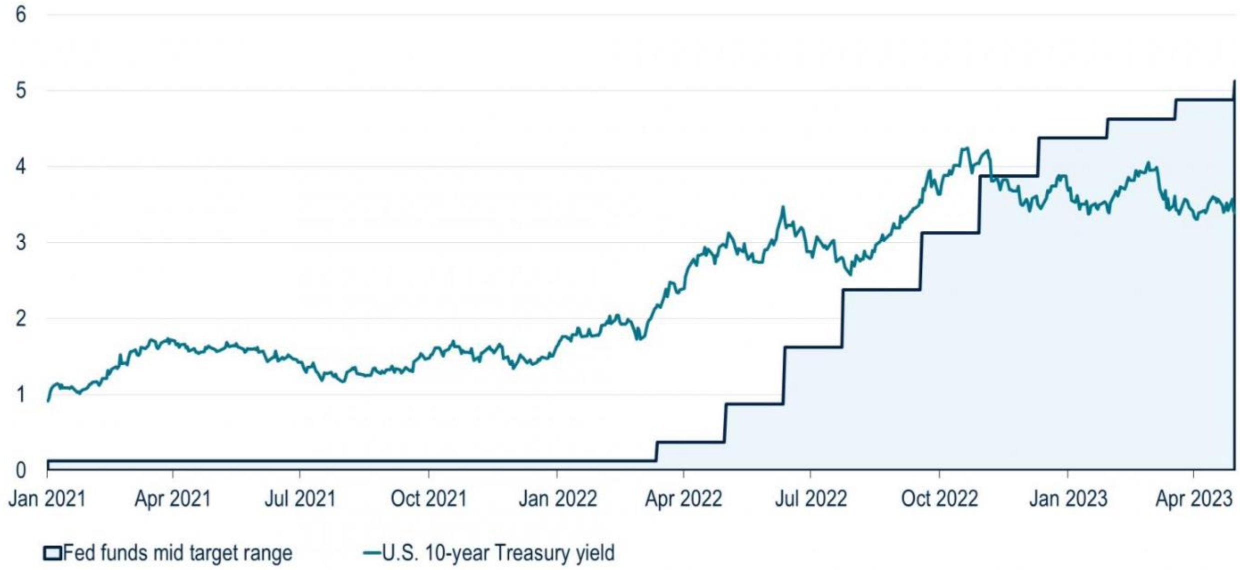
Despite the non-committal guidance offered today, we think this will be the last rate hike of the cycle - particularly since the debt-ceiling impasse may have reached a crisis point by the time of the June meeting. Looking ahead, we expect the Fed will cut the policy rate by 75 bps starting in Q4 of this year once the labor market confirms that the economy has softened markedly and that inflation pressure is receding towards the Fed's target. In our judgment, a mild recession remains the most likely macroeconomic scenario over the next 12 months, though we continue to see an appreciable chance of continued expansion if the Fed takes its foot off the brakes in a timely manner.

Markets outpace a pivot, leaving long rates biased to move higher

When the 10-year Treasury yield hit its intraday peak of 4.34% in October of 2022, the markets essentially cast their vote: rates have gone far enough, it's just a matter of time until the Fed pivots from hikes to cuts.

Fast forward to today's FOMC meeting: current market pricing shows more than 200 bps of rate cuts by the second half of 2024 as a mean expectation. Current market pricing shows more than 200 bps of rate cuts by the second half of 2024 as a mean expectation. With the Fed funds rate now just north of 5% and the 10-year yield south of 3.4%, yields are likely dredging along the low end of their range, with odds favoring higher long rates in the months ahead (Figure 1).

FIGURE 1: After a notable rally, the 10-year Treasury yield appears poised to move modestly higher (%)



Source: PGIM Fixed Income and Bloomberg.

Spreads: volatile, but the range may yet hold, buoying long-run prospects for spread product

For their part, spreads also crested in Q3 2022 and have subsequently remained range bound. While not particularly high from a longer-term perspective, they nonetheless remain elevated relative to pre-Russia invasion levels (Figure 2). If and as the Fed funds rate has peaked, fixed income flows are likely to prove bond supportive, keeping credit spreads within the range of recent months, allowing spread product to continue registering positive excess returns in the months ahead.

FIGURE 2: Range bound spreads maintain the potential to generate positive excess returns ahead (LHS %; RHS bps)

Source: PGIM Fixed Income and Bloomberg.

Conclusion

The Fed may be done hiking rates with cuts to come by year end. The markets, however, have already priced in a fairly aggressive easing cycle, suggesting some upside risk for long rates. Credit spreads are likely to remain range bound thanks to strong investor demand, allowing the spread sectors to continue registering positive excess returns.

[1] JOLTS refers to the Jobs Openings and Labor Turnover Survey, which is published by the U.S. Bureau of Labor Statistics.

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of May 3, 2023
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