Bond Blog

PGIM FIXED INCOME

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Fed Reignites the Search for Yield

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

As the Federal Reserve inches toward its terminal policy rate, markets focused on its commitment to data dependency. Bolstered by broadening expectations for a moderation in growth and inflation data, a reignited search for yield fueled the rally across all fixed income assets.

Wednesday's FOMC meeting revealed that the Fed leadership still sees an asymmetric risk profile for monetary policy - the risk of doing too little on monetary tightening is still greater than doing too much. As a consequence, the Committee kept unchanged the key sentence in the statement, indicating that it "anticipates ongoing increases in the target range" for policy. In the presser, Chair Powell doubled down on this view, pointing to the upside inflation risks from an exceptionally tight labor market and the possibility of hiking even more than the 5.25% median projection reflected in the December Summary of Economic Projections.

By inference, Chair Powell believes the Phillips curve, which describes the relationship between inflation and unemployment, remains steep - even against mounting evidence that wages and prices are moderating despite the tight and imbalanced labor market. With this as the backdrop, the message delivered by Chair Powell today was resolute: "we're not there yet" on the policy rate peak; and "when we get there, we'll stay there" for longer than markets expect and perhaps go further if required.

Markets rallied strongly despite the hawkish message because investors know the Fed isn't omniscient, nor is it dogmatic. Economic conditions are in charge when the central bank is in data-dependent mode, and market participants see a greater downside for inflation and growth than the Fed - an observation that Chair Powell made in the press conference. The most dovish aspect of the meeting was Chair Powell's interpretation of why financial conditions have loosened in recent months. Instead of characterizing easier market conditions as a misunderstanding of the Fed's reaction function, he explained it as a difference of opinion about the pace and extent of disinflation we're likely to see this year. Our view is the market's read is likely the more accurate one, and we maintain our expectation for the Fed to pause its rate-hike campaign in March at 5% as convincing evidence of broad-based disinflation continues to mount.

Furthermore, it's important to remember that central banks and investors have a different balance of risks. For Chair Powell, the greatest danger is for inflation to spiral upward. For market participants, however, the risk is in missing out on an outsized market rebound as disinflation takes hold.

Markets Buoyed by the Hike; Why and Where to from Here?

Following a muted reaction to the rate hike and statement release, risk appetite surged and the entire yield curve lurched lower as the Chair intimated that the Fed's path was indeed data dependent. Given the steep descent in the pace of economic growth and inflation in recent months, markets are assuming that following one more hike, the Fed will have adequate evidence that inflation is under control and will actually begin to steadily cut rates later this year. As this "data dependent, but assumed dovish" market read took hold in the interest-rates complex, risk appetite surged, taking stocks higher and credit spreads narrower.

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FIGURE 1: Following another 25 bp hike to just below 5%, the markets are assuming an average Fed funds rate next year of roughly 3.4% and sub-3% rates, effectively, in the years beyond. This may be a bit aggressive in terms of timing and degree of rate cut pricing and, therefore, long-term rates may have a mild upward bias.

Source: PGIM Fixed Income and Bloomberg.

FIGURE 2: After initially hesitating, stocks rallied and high yield spreads narrowed, buoyed by the Fed's apparent willingness to react in a data dependent fashion.

Source: PGIM Fixed Income and Bloomberg.

This market reaction - and indeed the markets' progression over the last few months - suggest investors are focusing on the big picture: interest rates have not been this high for more than a decade, the Fed is on the precipice of containing inflation, and interest rates will consequently decline in the quarters to come. Hence, the reaction of "get in now, don't miss out."

While we agree with the long-term premise that we are in the general zone of an interest-rate peak, i.e., "a strategic buy zone", we see pricing in the middle of the yield curve as a bit vulnerable to a scenario where the Fed does not rapidly pivot

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to cutting rates.[1] Additionally, if and as the Fed funds rate ends up remaining at 4%+ levels for some time, some upward pressure on long-term rates could materialize as well.

Meanwhile, a number of factors are lending firm support to credit markets. First, the stabilization of yields is reigniting a search for yield across fixed income sectors. In contrast to 2013, 2018, and 2022 - i.e., non-recession years where rising interest rates and high volatility pushed credit spreads dramatically wider, despite strong underlying credit fundamentals - years like 2017 and 2019 saw growth moderate, interest rates fall, and credit spreads contract. The bottom line across these cycles is that in the absence of a recession, a moderation in growth and stabilization of interest rates is favorable for spread product. With the market well braced for the Fed funds rate to approach 5% and then decline modestly over time, interest-rate volatility is likely to decline, flows into fixed income are likely to remain positive, and spread markets should remain well supported.

Conclusions

While the market may suffer some setbacks over the course of the year if the Fed fails to fulfil investor expectations for rate cuts, from a long-term perspective interest rates appear to be in a “strategic buy zone.” As a result, investors may continue to support the bond market, anxious to lock in the highest yields seen in over a decade.

[1] See “Yield is Destiny; Bonds are Back” and PGIM Fixed Income’s Q1 2023 Market Outlook

Source(s) of data (unless otherwise noted): PGIM Fixed Income, as 2/1/2023.

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