

Is the Market Pricing Something Different than the Fed Is Saying?

- Fed Chair Powell and his colleagues have explicitly communicated they believe policy rates need to rise further - and stay there - for a considerable period of time.
- The market should not expect a sharp reversal in policy – a “pivot” - back to easing soon after peak policy rates of 3.75% (estimated) are reached.
- However, a quick look at the **Fed Funds futures** market shows the contrary, currently pricing a pivot in the Fed funds rate to lower levels, i.e. rate cuts, starting sometime in 2023.
- So what does this all mean? In short, the market is pricing that the Fed will hike rates until something breaks in the economy. Once that happens - if that happens - then the Fed will be forced to cut rates quickly, and by a sizable amount.
- Given this uncertainty we continue to advocate for a balanced approach, namely a fixed income allocation that incorporates floating rate and high-quality short-duration assets, active management, even longer duration investment grade, all with a blended duration of around 3 years.

“ Hello, this is Jim Caron, portfolio manager and chief strategist on the fixed income team. What I'd like to discuss today is something more technical in nature, whereas many of my previous audiocasts tend to be based more on fundamentals. But when investing, what one has to understand is that there is a technical and quantitative component to understanding risk. As importantly, one has to figure out what the markets are actually saying, then try to evaluate that risk.

The key today is to try to understand if the market is pricing something different than what the Fed is actually saying. The place we look to is the Fed funds futures market. Now, what a lot of people do is look at the futures market and say, aha, what the market is pricing in six, nine, twelve months time is the following, which means the market is saying something like the Fed is going to hike rates up 3.75 or 4% and then start to cut rates rather quickly thereafter going into 2024. In essence the markets are saying the Fed is going to pivot sometime soon. The problem is that the Fed is saying that we have no intention of doing that at all. There is a distinct difference right now in terms of what the futures market is saying and what the Fed is actually saying and there are risks associated with this. Let me get into it.

Powell and his Fed colleagues have explicitly and clearly communicated that they believe policy rates need to rise and stay there for a considerable period of time. The market should not expect a sharp reversal in policy - or pivot - towards easing soon after policy rate hikes based on what they just told us. However, if we take a quick inspection of the Fed funds futures curve it's indicating the contrary. If price is a pivot in the Fed funds rate towards lower levels, starting sometime in the second quarter of 2023, that indicates that the Fed may start cutting rates and start lowering rates more quickly into 2024.

So what's going on? The short answer is that the market is pricing that the Fed will hike rates until something breaks in the economy and they're going to do this in order to control inflation. Once, or if, that happens, then the Fed will be forced to cut rates quickly and by a good amount. Let me explain a bit more. If we want to add some clarity to what the market's pricing and to try to understand what the Fed funds futures market is really telling us, we need get into the weeds a bit on how futures start to get priced and why the levels "are what they are" in the future. You will hear and see many comments in many charts that show a decline in the Fed policy rates in 2023, an indication that the Fed may be immediately switching from hiking to cutting. That's the pivot that we're talking about sometime in mid-2023, despite what Powell has already told us in Jackson Hole.

To simplify futures pricing, one must see the price level as representing a non-arbitrage level derived from hundreds of thousands of path dependent scenarios, potential scenarios of outcomes in the future. When you look at all of these scenarios, you derive a probability distribution at discrete points in time in the future. It's like saying, "well, what do we think?" the probability that the Fed is higher or lower than 4% by say June of 2023. That distribution gives you the probabilities.

The issue is that distributions aren't always perfectly symmetrical and can have fat tails and skinny tails, meaning that you may have a higher probability for a bad outcome than a good outcome. You therefore start to get a skew in in the overall pricing and it starts to create the pivot. Said differently, what the markets are implying is that once the Fed gets to their peak policy rate, which they're telling us is between 3.75 and 4%, that they would then hike rates above that level by less and slower than if they needed to cut rates. Let me say that one more time. Once the Fed gets up to their peak policy level of say 3.75 to 4% it's going to be harder for them to increase rates incrementally from that level. Really positive things need to be happening in order for that to happen.

But if the opposite was happening, something bad was happening like a slowdown, the Fed would more likely cut rates a lot faster from their peak level of 4% than they would be able to hike rates above 4%. We now understand there's a skew in this distribution. Once the Fed funds rate reaches 3.75 - 4% it's harder for rates to move higher than it is for rates to move lower. It's another way of saying that is that once you get towards the end of the rate hiking cycle, it's harder for rates to continue to move higher and ultimately rates tend to start to fall. That's essentially what is forming this pivot and that's the way that we have to look at it.

Taking this into account, the Fed funds futures market reflects a fatter tail scenario for a bad economic outcome within the next 6 to 9 months. That's where we start to see the pivot that stops the Fed from hiking, or doesn't even allow them to get to 3.75%. It builds in some possibility of rate cuts. And again, if the Fed has to cut rates, they're likely to cut rates very, very quickly after they reach their peak level, creating a big fat tail in the distribution. As a result, the pivot actually represents an average price for all of these scenarios for Fed funds at some point in the future that's lower than the 3.75 level. Again, that starts to form the pivot. Another way to think about this is that paying for minimization of downside risk against the negative outcome should be more costly than paying for the minimization of downside risk against a positive outcome. Because as the Fed continues to hike rates as they get near the end of their cycle, typically something slows down in the economy and breaks so therefore that the cost of

minimizing downside risk against that for that bad outcome should cost you more than what it actually costs if you get a positive outcome out of this. Again, think of this is in terms of probability distributions.

It makes sense because the Fed has been hiking rapidly and it's likely to be closer to the end of their cycle than the beginning. If this were not the case, then what would happen? I talked about this non arbitrage condition. If this were not the case, then then the options market would arbitrage the Fed funds futures prices higher, implying a lower Fed funds rate, the pivot, until the density of the probability distribution is balanced. That's really what the pivot represents. It's saying that the Fed is trying to magically engineer a soft landing, that they're going to hike rates to 4% and then they're going to notice that they've gone too far and then they're going to gently start to bring those rates down, and that we're going to have this beautiful, wonderful soft landing. Certainly, that's a scenario. Certainly, that's a possibility.

But from a pricing perspective, the way the markets are thinking about this is that as the Fed continues to hike rates, and if they get to those high levels, something is more likely to break. They have to then build in that possibility for a negative economic outcome and lower Fed funds futures at some point down the road. When we think about all this context it is important to make sense of the overly simple narratives that are out there. That the Fed funds futures market is pricing opinion, and that the market doesn't believe the Fed. You can be simple and say it that way and there's no question. And it's okay to say it that way. But you just need to internalize and understand what the market's actually telling you in terms of risk because that can alter your decisions when you're starting to invest.

So let's talk about valuing assets. After the Fed peaks in 2023, policy rates start to decline. What we have to understand is how default risks and credit risks start to react to that. You need to take this into account and this should be incorporated into any projections made about asset prices. So we said before that the market seems to accept that policy rates are going to this 3.75 to 4% level, but the market is not properly priced for if the Fed hikes well beyond 4% or that as the Fed is hiking until something breaks in the economy and the Fed is then forced to cut. Right now, what the markets are telling us is that their pricing something to break in the economy from all of these rate hikes. Let's not look at the future and say, well, the markets OK, everybody is very happy that that's going to introduce a soft landing. We shouldn't have to worry about anything. It's time to take on a lot of risk.

However, the Fed funds futures market is saying, no, we're actually discounting that there is going to be this risk in the future. If getting to a 2% inflation target is the primary goal for the Fed, that means the Fed is willing to risk a deeper recession and hike until something breaks. I talked about this in the R. I. P. Cycle last week, Recession, Inflation and Policy risks. The Fed's focus right now is on bringing inflation down and they're willing to risk a recession in order to do that. And by keeping rates high for a long period of time, the likelihood for a deeper recession starts to increase. That's the other reason why you see a decline in Fed funds futures pricing in the future.

So how do we interact with this from the market's perspective? Well, we still advocate for a balanced portfolio approach given the uncertainties that lie ahead. We suggest a fixed income allocation that incorporates floating rate assets, to take advantage of higher rates, and high-quality, short-duration

assets. We also strongly urge that we start to move into some actively managed strategies where the manager can make duration, credit and asset allocation decisions around the world to try to build a more durable portfolio. We even advocate for some longer duration, good old-fashioned investment grade fixed income because you want to have high quality long duration assets in your portfolio in case something does break. If rates do go down, you want to be able to participate in that kind of a move in a big way. You're going to get that from a longer duration, high quality assets. Blended together, we believe the proper duration for a balanced fixed income portfolio that incorporates floating rate, short duration, active management, IG should be about three years. We still like that overall average duration for an investment portfolio and fixed income.”

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