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# Global Fixed Income Strategy

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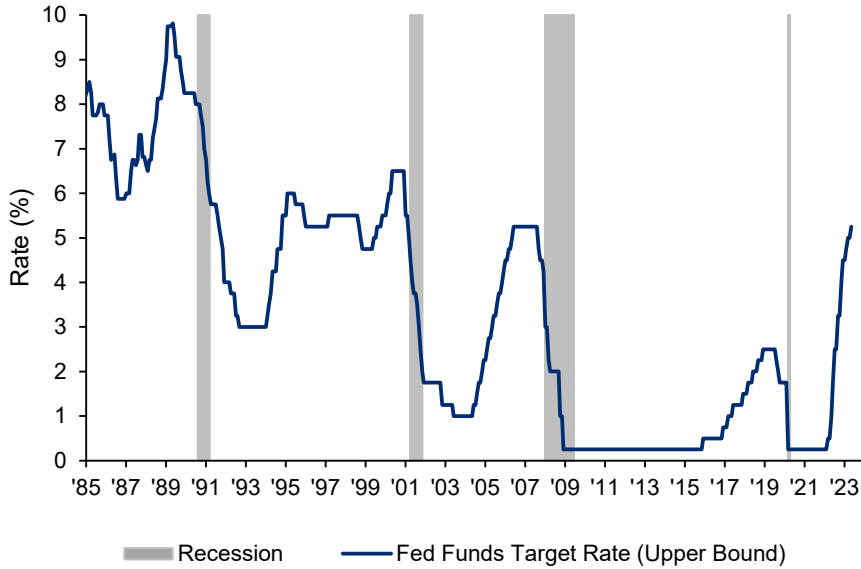
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## Rates back to 2007 levels | FOMC raises Fed Funds rate by 25bps to 5.25%

- **At their May meeting, in a unanimous vote the Federal Open Market Committee (FOMC) raised the Fed Funds Target Rate range by 25 bps to 5.00-5.25%, as expected by the market. This brings the target rate – and perhaps the terminal rate of the cycle – to right on top of the median dot plot expectation from the March meeting (5.125%).**
- As they did last month, the FOMC statement noted banking system stress, although it actually brought forward “tighter credit conditions” to being a current situation as opposed to a prospective one: “*The U.S. banking system is sound and resilient. Tighter credit conditions for households and businesses are likely to weigh on economic activity, hiring, and inflation. The extent of these effects remains uncertain. The Committee remains highly attentive to inflation risks.*”
- **This is possibly a “dovish pause”, but the FOMC statement and Chairman Powell’s subsequent press conference were ambiguous. The Federal Reserve omitted language from the previous FOMC statement that “some additional policy firming may be appropriate”. Instead, going forward the FOMC “will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments.” This shift in language provides the Fed with more optionality to perhaps adopt more of a balance-of-risks approach to further rate hikes, but it didn’t take them off the table.**
- **This marks the highest Fed Funds rate since August 2007, which at the time was the peak rate of the cycle before the Fed proceeded to cut rates down to near-zero (Figure 1).**
- **For now, the markets have priced out any further rate hikes for the year, though Powell specifically noted in his press conference that “a decision on a pause was not made today”, but that the Fed is close to and “possibly at” a sufficiently restrictive rate level.**
- The Federal Reserve’s “quantitative tightening” program continues balance sheet reduction every month, primarily through Treasuries. The Fed’s holdings of securities outright have declined since the summer of 2022 by almost \$650bn from \$8.48T to \$7.85T as of April 27th. But following the start of the U.S regional banking crisis in mid-March, an additional \$328bn of the Fed’s balance sheet is being used as banks sought liquidity by pledging securities for cash loans through various Fed lending programs such as the Discount Window, the new Bank Term Funding Program, and loans to depository institutions established by the FDIC. (We do not view these programs as providing new, durable liquidity, but rather as temporary loans and are generally secured by collateral from the borrower).
- The bond market rallied slightly on the initial announcement as more rate cuts were priced into the curve, with year-end Fed Funds now priced at around 4.40% (Figure 2). The Treasury yield curve remains deeply inverted, but the degree of inversion has moderated over the past few months. 2-year Treasury yields at 3.93% are now only about 54bps higher than 10-year Treasury yields, down from over 110bps just two months ago right before the banking crisis (Figure 3). While an inverted yield curve typically precedes a recession with some lag (6-18 months), the subsequent re-steepening of that inverted curve has often signaled that recession risk has risen in the near-term (Figure 4). Equity market reaction was very muted initially.

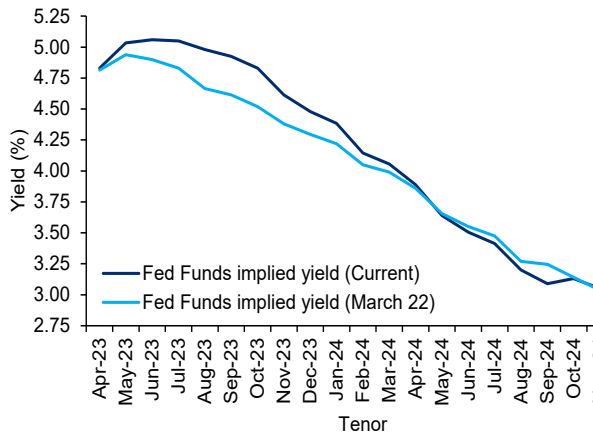
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**Figure 1: Fed Funds Target Rate (Upper Bound)**

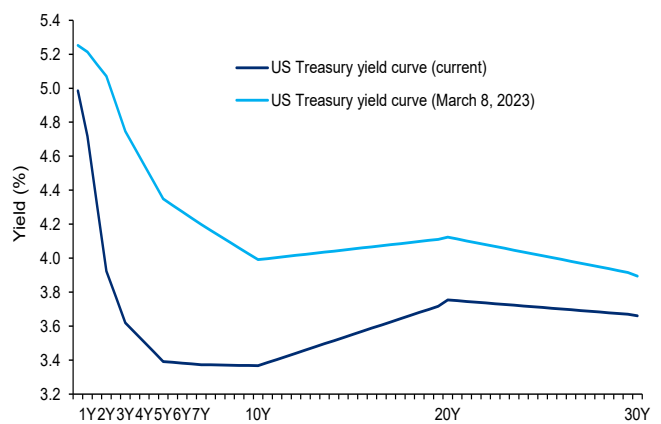


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**Figure 2: Fed Funds forward curve**

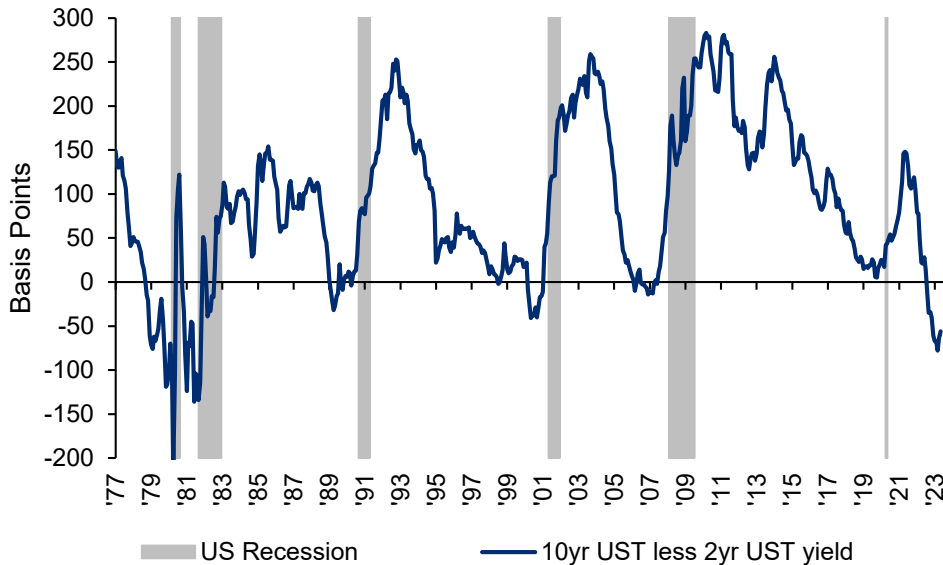


**Figure 3: US yield curve, current vs March 8th**



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**Figure 4:** US Treasury yield curve, 2s10s



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## Our takeaway:

**Going into its two-day meeting this week, the Fed found itself deliberating once again right on the heels of another bank failure.** This time it was First Republic Bank, the 14<sup>th</sup> largest bank in the US by total assets (\$229 billion as of 4/13/23). First Republic became the second-largest bank failure in US history, beating out Silicon Valley Bank (SVB) previously in second place which had entered receivership only a few months before (\$167 billion in total assets). In addition to these failures, regional banks stocks (as measured by an ETF) were lower on the week through Tuesday by 9%, with several smaller regional bank equities down this week by over 20%. The Fed had indicated last meeting ([see our last Fed update: Keep Calm and Cautiously Hike On](#)) that within the context of its overarching goal of bringing down inflation, the previous bank failures of SVB and Signature Bank were primarily viewed as effectively adding some degree of additional monetary tightening, rather than as a cautionary tale that monetary tightening was already overly restrictive.

**The Fed today decided to hike by 25bps again, and while softening its stance on future rate hikes, it nevertheless communicated as it so often has that it would be “guided by data” for future rate hikes.** Similarly, it has no plans to reduce its monthly Quantitative Tightening (QT) target of \$95bn per month. But the costs of its policies are growing quickly, and one would presume that the more the Fed hikes (and engages in QT) at this stage the more damage to the economy it will ultimately transmit. In addition, **this meeting did nothing to change the Fed’s public view of the simmering stresses affecting (primarily) regional banks. If anything, Powell seemed to downplay the most recent turbulence, stating “banking sector conditions have broadly improved” since early March.**

Put simply, for the Fed the regional banking crisis is not yet – in and of itself - a sufficient reason to pause future rate hikes if deemed appropriate, given other economic conditions. That being said, the Fed did leave open the door that they may be done hiking rates – yet once again abandoned any real forward guidance by almost mechanically tying their policy going forward to monthly inflation rates and employment prints (as well as presumably banking conditions), rather than attempting to adjudicate a reasonable projection of how its current policies might impact that data in the near future. **Powell noted that a “data-dependent approach” will be used to determine the need for more rate hikes, with decisions on a meeting-by-meeting basis, “but we are prepared to do more” and “we are no longer saying that we anticipate, we will be driven by data.”**

This “keep calm and hike on” attitude of the Fed is somewhat disconcerting, as the Fed actually explicitly stated today that monetary policy is both cumulative and operates with a time lag. **Now that it appears the monetary tightening is starting to have a meaningful impact, it is worth considering the history of the market the last time the Fed held rates at 5.25% in 2007.** Although there are many, many difference between now and then, the precipitating “event” of the Great Financial Crisis

was not Lehman's bankruptcy in October of 2008, it was when two Bear Stearns sponsored collateralized debt obligation funds couldn't roll their short-term funding and had to be provided loans by Bear in June of 2007 (Bear went on to fail in March of 2008). Shortly after Bear's bailout of its funds, the FOMC in August of 2007 made a very brief mention of increased financial turbulence stating: "*Financial markets have been volatile in recent weeks, credit conditions have become tighter for some households and businesses, and the housing correction is ongoing.*" However, in justifying their decision at the time to keep rates at 5.25%, the FOMC went on to say: "*Although the downside risks to growth have increased somewhat, the Committee's predominant policy concern remains the risk that inflation will fail to moderate as expected. Future policy adjustments will depend on the outlook for both inflation and economic growth, as implied by incoming information.*" This sounds somewhat similar to today's statement. For the record, the Fed went on to start cutting rates at its next meeting in September and didn't stop cutting until they reached zero in December 2008.

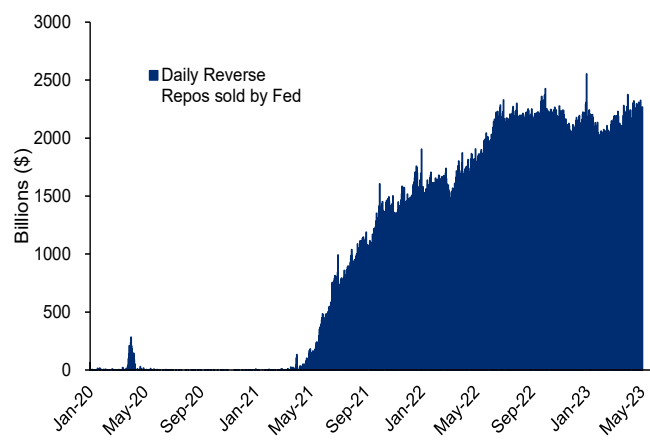
**To be clear, we do not think this recent turbulence in banks will metastasize into another major financial crisis.** For the larger banks especially, there are major differences between today and 2007 in terms of asset quality, breadth of bank business lines, levels of capitalization, etc. But there is nevertheless important "information" being conveyed by this current regional bank stress, and that is simply that rates are now a point where some group of "weaker" leveraged entities are at risk of failing due to their own particular business models – and the question becomes "which ones"? The reaction in bank equities the last few days suggests that many participants may be willing to sell first and ask questions later – meaning that this price action risks becoming a more systemic market liquidity issue as investors eschew the sector altogether. Accordingly, if this crisis gets worse, the Fed is going to need to more explicitly acknowledge "financial dominance" in its reaction function calculation than they have thus far: i.e., that central banks' first duty is to protect the stability of the financial system.

**In our view it is unfortunate that the Fed did not pause today and went ahead and hiked, but as we said after the last FOMC meeting, perhaps the Fed is trying to avoid the appearance of undue concern. Powell did address the banking stress, but it is unclear if his comments will prove to have been helpful. Powell's comment that the "3 banks" resolved were at the heart of the original contagion and that First Republic's sale was an "important step" toward ending the turmoil is a risky one that may cause market concern since the stress does not appear to be fully resolved.**

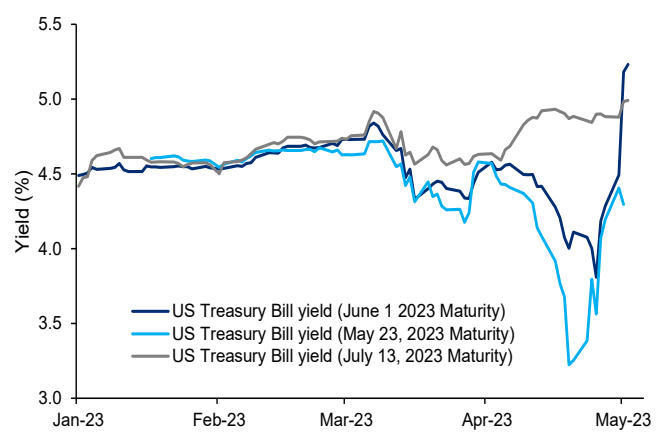
Indeed, Powell actually stated at his press conference that "*monetary policy tools and financial stability tools are not in conflict.*" However, that doesn't seem to be entirely accurate. The Fed's policies and various programs are having numerous contradictory impacts at these extremely high interest rate levels. While much has been made of the negative impact of higher yields on banks' high-quality securities holdings, the higher Fed Funds rate impact is becoming especially apparent in the Overnight Reverse Repo Program (ON RRP). This program was started back in April of 2021. It was designed to allow money market funds – who at this time of massive quantitative easing (QE) in 2021 had nowhere to invest their cash since banks were turning away deposits – to in effect deposit their funds back at the Federal Reserve and receive a rate above 0% (yes, T-bills at one point that spring briefly traded below 0%). Crucially, the rate on the RRP was set at 20bps below the "upper band" of the Fed Funds rate (so today for example the RRP rate is now 5.05%). Naturally, as rates have risen, money market funds have flocked to use this program and it has grown to over \$2 trillion in size (**Figure 5**). In effect, the program is now likely creating some degree of competition at the margin for bank deposits since the rate is so high. The funding is overnight, and it is (presumably) "risk-free" since the borrower is the Federal Reserve itself. Perhaps growing somewhat alarmed at the arbitrage implications, the Fed actually stated on April 25<sup>th</sup> in a little-noticed announcement that it would not accept new funds whose sole purpose was to invest in the RRP: "*expectations and eligibility criteria for Reverse Repo (RRP) counterparties have been updated to clarify that accessing RRP operations should be a natural extension of an existing business model, and the counterparty should not be organized for the purpose of accessing RRP operations.*"

The RRP likely acts as a drain of sorts on bank deposits but given the impending US debt ceiling "X-date" sometime likely in early summer (the day when the US Treasury's cash reserves run out), it's possible that the RRP will attract even more funding from money market funds trying to avoid owning T-bills that mature near this X-date. Certainly, T-bill yields maturing before the expected X-date are trading at yields well below Fed Funds (and the RRP) while yields in the expected X-date window have started to jump higher (**Figure 6**). At one-point last week 1-month bills were paying 170bps less than 3-month bills, the largest difference ever. In the last few days, bills maturing in June and July have shot up in yield, with June 6<sup>th</sup> T-bill currently sitting at around a 5.5% yield. We think the US government will come to an agreement on raising the debt ceiling in time, but there will likely continue to be significant volatility in these very short-dated T-bill prices until they do.

**Figure 5: Fed's Overnight Reverse Repo Facility**



**Figure 6: Selected US Treasury Bill yields, by maturity date**



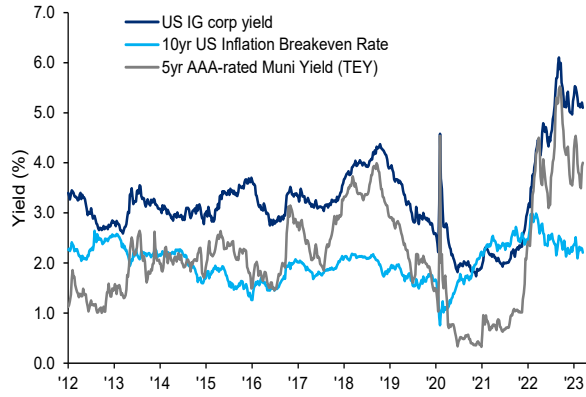
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There are many implications of the current Fed outlook for fixed income investors. First, while we ultimately believe the 10y yield will decline by year-end to near a 3% rate (vs 3.39% today), **rates at the longer end may stabilize and actually move slightly higher for some time if banking stresses recede near term, as that might bring another rate hike into view and/or reduce the chance of rate cuts later this year.** While this is more of a “tactical” shorter-term view, current pricing in the Treasury market likely reflects considerable “fear premium”. **This would argue for adding intermediate duration in the 1–5-year area for now, with the shorter-end (1 year) offering the most yield.** Should there be a sudden “risk event”, total return for longer-term Treasuries might outperform shorter-term Treasuries, but it is also possible (and perhaps even more likely) that the “front-end” of the yield curve would benefit considerably from a rapid pricing of expected Fed rate cuts of even more than are already priced. **That being said, for clients who do not have any longer-term duration, we would suggest they consider adding in order to have a “blended” overall duration for their core fixed income holdings closer to around a 5-year area.**

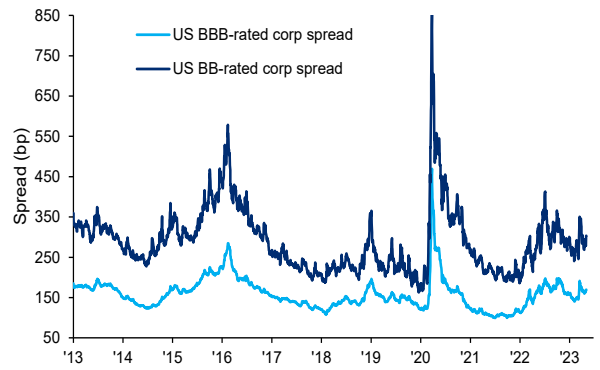
**Our view of a 3% 10y at year-end is more premised on two macroeconomic expectations of our Strategy team.** First, that inflation trends lower by year-end toward 3.5%, allowing the Fed to not only “pause” its rate hikes but also consider rate cuts with less concern about possibly re-spiking inflation after the cuts. Second, the team expects a high chance of recession in the second half of 2023. We expect this recession to be mild, but nevertheless to increase unemployment above 5% from its current 3.5% level. **If these events transpire, we think the Fed will begin cutting rates by the fall, perhaps by as much as 100bps or more by year-end, with cuts most likely in the 4<sup>th</sup> quarter. The market is currently pricing about 75bps of cuts by the 12/16/23 meeting to a level of about 4.40%.**

Second, because of recessionary concerns investors should consider higher credit-quality corporate bonds (or municipal bonds, for tax advantaged investors), whose spreads have risen considerably due to bank stress and so continue to offer much higher yield now vs expected inflation (Figure 7). **Because we expect only a mild recession, for clients who are aware of the risks they might consider adding corporate bonds with rating levels as low as BB. This credit rating segment offers spreads of about 300bps currently on average, almost 130bps pickup vs BBB-rated bonds (Figure 8).**

**Figure 7: US IG corp and Muni Yields vs BE Rate**



**Figure 8: US corp bond spready by credit quality**



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<b>Credit risk</b>			
<b>Investment Grade</b>			
Highest quality	Aaa	AAA	AAA
High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>Not Investment Grade</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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