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Joseph Lavorgna, Chief US Economist | 212.610.1741 | joseph.lavorgna@smbcnikko-si.com

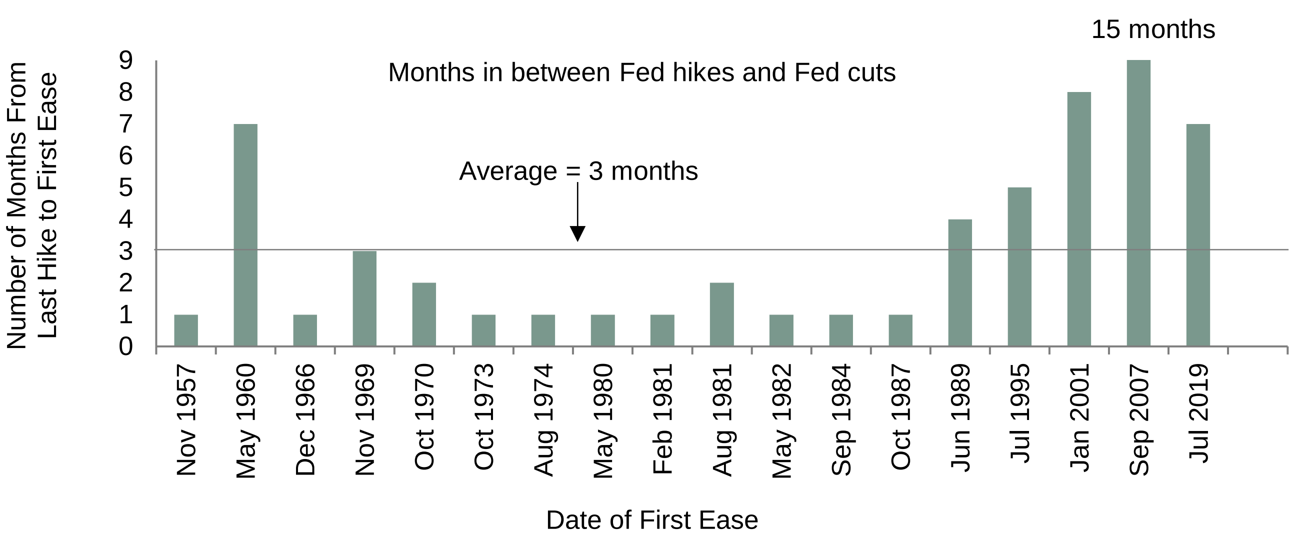
Is the Bond Market too Pessimistic?

The Fed has raised rates at its fastest pace since the 1981-82 tightening cycle which in turn has lifted the level of the long-run real interest rate well into restrictive territory. And the Fed is not done. Last year's central tendencies showed a peak funds rate of 5.125% but recent Fed commentary (Presidents Bullard and Mester) hint of higher peak rates (5.37%). If so, another 75 basis points (bps) in cumulative hikes between now and June is forthcoming.

This hawkishness is reflected in the market which has also begun to worry about the possibility of a July rate hike. **In turn the yield curve has inverted further with slope between 2- and 10-year treasury notes recently hitting a record low of -90 bps**. Wherever the Fed stops, it will be slow to reverse according to Chair Powell. The Fed has plenty of inflation fighting credibility. Just look at the 10-year inflation breakeven rate at 2.4% which is consistent with a 2% PCE deflator.

We worry the Fed is making a classic policy error by tightening rates too quickly and by too much. Monetary policy works with long and variable lags which means that a portion of recent past Fed actions has yet to be felt. Clearly, the Treasury market is telling us the same as the yield curve has never un-inverted without Fed easing. The issue is how long the Fed can keep rates in restrictive territory without pivoting toward easing. History suggests is it not long after what turns out to be the terminal rate. Perhaps the bond market has become too pessimistic on the prospects of a 2023 Fed pivot.

In the past, it has only been three months from the last hike to the first ease. But there has been lengthening over the last five cycles which have averaged eight months. However, the past five episodes did not experience the rapid tightening of the current tightening cycle, which leaves us highly doubtful the Fed can keep rates in restrictive territory for as long as policymakers proclaim. Instead, the Fed's tough talk is likely designed to prevent financial conditions from easing too much and to solidify anchored inflation expectations. The financial markets have finally listened, as they have removed nearly all of the 2023 easing that had been priced. But is the bond market now too pessimistic? We think so.



Source: FRB, Haver, SMBC Nikko

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