Bond Market to the Fed: We Don’t Believe You

The bond market is always right. That is what the yield curve has taught us. Every time the slope is negative, a recession ensues. This time is not different. Our preferred metric is the 2s10s curve, which is around -80 basis points (bps). This is the biggest inversion since 1981 but is much larger in relative terms if we normalize for today’s lower yields. For us, the only questions are, when does the recession start, and how deep is it?

Yesterday’s FOMC statement, press conference and economic forecasts were all hawkish. The Fed raised its estimate of the terminal funds by 50 bps to 5.125%, which policymakers expect to hit next year. In our view, this implies three successive 25 bp rate increases beginning next February. The Fed told us to expect the funds rate to remain at 5.125% through the remainder of 2023, with the first cuts(s) coming in 2024 and totaling only 50 bps. The bond market does not believe these forecasts and neither do we.

On Monday the futures market was pricing a 4.73% December 2023 fed funds rate. This implies a 25 bp rate cut in next year’s peak funds rate of 4.875%. Despite the new FOMC forecasts, fed funds futures are still expecting a 4.875% terminal rate. More importantly, the bond market is now predicting a large 75 bps in rate cuts by the end of next year. In the chart below, we show the implied FOMC rate forecasts versus market expectations. What a difference between the Fed and the market! But if our real GDP growth and inflation projections are accurate, 2023 official rates are likely headed lower sooner and by an even larger amount than the market thinks.

As our past work has demonstrated, the shift from monetary tightening to easing is fast. Over the past 18 hiking cycles, the average time from the last rate increase to the first rate decrease is three months. In addition, when recession risks are elevated, the Fed tends to move aggressively, certainly more than what is currently built into the futures market. Nevertheless, the broad contours of the bond market’s rate trajectory are correct.

Source: Bloomberg, FRB, Haver, SMBC
Disclaimer

This presentation is for discussion purposes only and is not intended to be an offer to sell or the solicitation of an offer to buy any securities, or any commitment to underwrite, subscribe for or place any securities, is not an offer or commitment to provide any financing or extension of credit or service, and does not contain any tax or legal advice. This presentation has been prepared by SMBC Group (which may include, collectively or individually, any of the following entities in the Americas Division: Sumitomo Mitsui Banking Corporation (“SMBC”), SMBC Nikko Securities America, Inc. (“SMBC Nikko”), SMBC Nikko Securities Canada, Ltd. (“Nikko Canada”), SMBC Capital Markets, Inc. (“SMBC-CM”), SMBC Leasing and Finance, Inc., JRI America, Inc., and SMBC Rail Services LLC) and is being furnished by SMBC Group solely for use by the client or potential client to whom such materials are directly addressed and delivered. This presentation is confidential and is the property of SMBC Group subject to copyright. Any reproduction of this presentation, in whole or in part, is prohibited, and you may not release these materials to any person, except to your advisors and professionals to assist you in evaluating these materials, provided that they are obligated, by law or agreement, to keep the presentation confidential. These materials do not constitute research, a recommendation or an offer or solicitation to any person to enter into any transaction or adopt any hedging, trading, or investment strategy. Prior to participating in any such transaction, you should consult your own independent, competent, legal, tax, accounting, and other professional advisors.

In preparing this presentation, SMBC Group has relied upon information available from third parties, including public sources, and we have assumed, without independent verification, the accuracy and completeness of such information. Specific prices, indices, or measures, including ranges, listed in this document were prepared at the time the document was prepared, and are subject to change without notice. SMBC Group makes no representations to and does not warrant this presentation's accuracy or completeness. SMBC Group expressly disclaims any liability for any use of the information set forth herein, including, without limitation, any use of the information set forth herein in the preparation of financial statements or accounting material.

These materials may contain forward-looking statements, which may include projections, forecasts, income estimates, yield or return, future performance targets or similar analysis. These forward-looking statements are based upon certain assumptions. All forward-looking statements are based upon currently available information and SMBC Group is not obligated to provide an update. Actual events may differ from those assumptions. Opinions, projections, price/yield information and estimates are subject to change without notice. There can be no assurance that estimated returns or projections will be realized, that forward-looking statements will materialize or that actual results will not be materially lower than those presented. Past performance is not necessarily indicative of future results. Any transactions or strategies addressed may not be suitable for all parties. The value, price or income from transactions or strategies may fall as well as rise. SMBC Group or an affiliate may have a position in any of the underlying instruments, assets, indices, or rates mentioned in this document. You should make your own independent judgment or seek independent financial and tax advice with respect to any matter contained herein.

SMBC is subject to Japanese firewall regulations and therefore absent client consent, non-public client information may not be shared with SMBC Nikko Securities Inc.

SMBC Nikko is a U.S. registered broker-dealer of SMBC Group. Nikko Canada is a U.S. and Canadian registered broker-dealer of SMBC Group. SMBC-CM is provisionally registered as a U.S. swap dealer with the CFTC. Capital markets and other investment banking activities for SMBC Group are performed by a combination of SMBC Nikko, Nikko Canada, SMBC Nikko Securities Inc. and SMBC-CM. Lending and other commercial banking activities are performed by SMBC and its banking affiliates. Derivative activities may be performed by SMBC-CM or SMBC. SMBC Group deal team members may also be employees of any of the foregoing entities. SMBC Group does not provide tax advice. Accordingly, any discussion of U.S. tax matters contained herein (including any attachments) is not intended or written to be used, and cannot be used, in connection with the promotion, marketing or recommendation by anyone unaffiliated with SMBC Group or for the purpose of avoiding U.S. tax-related penalties. © 2022 SMBC Group. All rights reserved.