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 it is 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
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.