INFOCUS

MACRO COMMENT

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Yield curve positioning

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HIGHLIGHTED IN THIS PUBLICATION:

- GLOBAL STRATEGIC ASSET ALLOCATION
- GLOBAL SECURITY SELECTION
- REGIONAL ASSET ALLOCATION
- REGIONAL PORTFOLIO CONSTRUCTION

The US Federal Reserve appears to be nearing the end of its rate tightening cycle. In this *Infocus* report, Economist Sam Jochim analyses the implications for fixed income investors and assesses yield curve positioning.

Having risen sharply from mid-2020 until mid-2022, inflation in the US appears to have peaked and is in a declining trend (see Figure 1). Despite the Fed's dramatic tightening of monetary policy, involving 500 bps interest rate increases over 14 months, inflation remains above the Fed's 2% target. While headline inflation has come down, core inflation, which excludes the volatile energy and food price components, has remained more persistently elevated. At 5.5%, it is far above the Fed's 2% objective. Debate therefore continues regarding whether the Fed is likely to increase interest rates further.

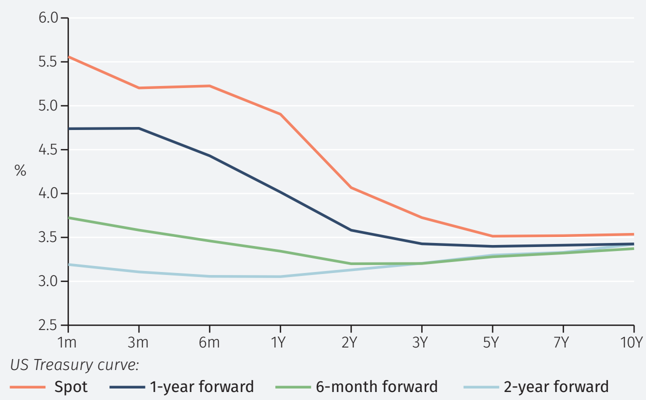
1. US headline and core CPI inflation

Source: Refinitiv. Data as at 15 May 2023.

Market expectations regarding interest rates have moved quickly. As recently as 8 March, markets expected the Fed funds rate to be 50 basis points above its current level after the FOMC's June meeting (see Figure 2) with a good possibility of further hikes at subsequent meetings this year.

However, following recent bank failures , it became evident that one trade-off the Fed faces is between stabilising inflation and ensuring financial stability. As a consequence, rate expectations quickly shifted and rate cuts are now anticipated towards the end of the year.

3. US Treasury yield curve



Source: Refinitiv. Data as at 12 May 2023.

This shift in expectations has been associated with a rally in fixed income markets. Treasury yields declined by around 40 basis points on average across the term structure from 8 March to 12 May.

2. Market expectations of federal funds rate (% probability)

	Fed funds rate	8 March 2023					15 May 2023				
		FOMC meetings dates					FOMC meetings dates				
		Jun-23	Jul-23	Sep-23	Nov-23	Dec-23	Jun-23	Jul-23	Sep-23	Nov-23	Dec-23
Rate hike	6.00 - 6.25%		10%	12%	10%	7%					
Rate hike	5.75 - 6.00%	26%	37%	37%	32%	25%					
Rate hike	5.50 - 5.75%	**54%**	**41%**	**39%**	**38%**	**36%**					
Rate hike	5.25 - 5.50%	18%	12%	11%	17%	23%	21%	13%	6%	1%	
Current	5.00 - 5.25%	1%			3%	7%	**79%**	**57%**	33%	8%	1%
Rate cuts	4.75 - 5.00%					1%		29%	**45%**	34%	9%
Rate cuts	4.50 - 4.75%								16%	**43%**	34%
Rate cuts	4.25 - 4.50%									15%	**41%**
Rate cuts	4.00 - 4.25%										14%

Source: CME Fed Watch Tool. Data as of 8 March and 15 May 2023. Probabilities below 1% are set to zero.

The possibility that the Fed funds rate has peaked has important implications for fixed income investors. Across the US government bond term structure, the yield is highest at the short-end of the curve as market participants are expecting short-term interest rates to fall in the months and quarters ahead (see Figure 3).

The inversion of the yield curve – the fact that short-term interest rates exceed longer term rates – is notable. This has historically been a strong predictor of recessions. Given that the cumulative impact of the large monetary tightening of the past year is yet to be fully felt, and credit conditions have tightened significantly, we believe it is likely the US economy will enter a mild recession later in 2023 or possibly early 2024.[1]

At the press conference following the latest FOMC meeting, Chairman Powell stated that it was more likely than not that the US would avoid a recession this year.[2] If there is a recession and it turns out to be deeper than expected, for instance because credit conditions tighten further, the Fed may cut rates by more than markets currently anticipate. However, if the labour market remains tight and core inflation persistently elevated, and the Fed adopts a more hawkish tone, it is possible markets begin pricing in more rate hikes. Risks today are in both directions and each scenario would have important implications for fixed income markets.

For example, over a three-year time horizon, an investor could invest in a 3-year Treasury and hold it until maturity. Alternatively, they could invest in a 1-year Treasury to gain a higher yield and then reinvest at maturity into another Treasury of the same tenor and continue to do so until the end of the three-year period (roll-over strategy).

If the path of interest rates is in line with market expectations, the returns of both strategies would be similar (see Figure 4). However, if the Fed cuts interest rates more rapidly than markets currently expect, the return on the roll-over strategy will drop below the level currently implied by futures markets (as depicted in Scenario A in Figure 4). This would result in total returns over a 3-year period falling below what would be received had an investor locked in yields for the entire period. If the path of interest rates is above what markets currently expect (as depicted in Scenario B in Figure 4), total returns over a 3-year period would be higher for the roll-over strategy than for locking in yields for the entire period.

In summary, the Fed has increased interest rates sharply in the past year in response to high inflation. Concerns about financial stability have accompanied a decline in market expectations for the Fed funds rate, with the risk of recession in the US rising materially. However, if core inflation remains elevated, the Fed could adopt a more hawkish stance. Interest rate expectations can move quickly and there are important implications for fixed income investors who believe that the future path of interest rates will differ from what is currently priced by markets.

4. Total returns implied by market rates and alternative scenarios (%) [3]

	Change in 1-year Treasury yield relative to current market expectations									
	Scenario A: Rates decline further than currently expected					Scenario B: Rates rise further than currently expected				
	-1.00%	-0.75%	-0.50%	-0.25%	0%	0.25%	0.50%	0.75%	1.00%	3-year Treasury
3-year total returns	8.5%	9.3%	10.1%	10.9%	11.7%	12.5%	13.3%	14.2%	15.0%	11.6%

Source: Refinitiv and EFGAM calculations. Data as at 17 May 2023.

1 See EFGAM *Infocus*, 'Bank lending standards and recessions', https://tinyurl.com/4c3a7rwm
2 https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20230503.pdf
3 Calculations based on data as at close on 12 May 2023. Returns compounded over three years. The scenario analysis assumes that rates fall or rise relative to current market conditions in each year over the three-year period. For example, a decline of 50 basis points per annum in the 1-year Treasury yield over the next three-years produces a return of 10.1%.

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