PGIM India Mutual Fund

INVESTMENT PERSPECTIVES | FIXED INCOME

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Post-FOMC market moves—even bigger in the “real” world

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The Federal Reserve took a somewhat more hawkish tone than expected at its meeting on June 16 against a backdrop of updated economic projections and assessments of the risks to that outlook. Ahead of the meeting, there was a risk that the Fed might not acknowledge enough of the transformed environment and thus might sound out of touch. The projections and discussions laid forth by the Fed, however, provided a very credible updated base case, in our view.

The Fed lifted both its growth and inflation forecasts for this year, in acknowledgement of the strength we’ve already seen. But despite weaker-than-expected job gains in recent months, the Fed maintained its view that the unemployment rate would improve significantly further by the end of this year. Meanwhile, growth, inflation and unemployment projections for next year were little changed. The takeaway? The Fed expects current inflation pressures and widespread shortage of workers will in fact likely prove temporary.

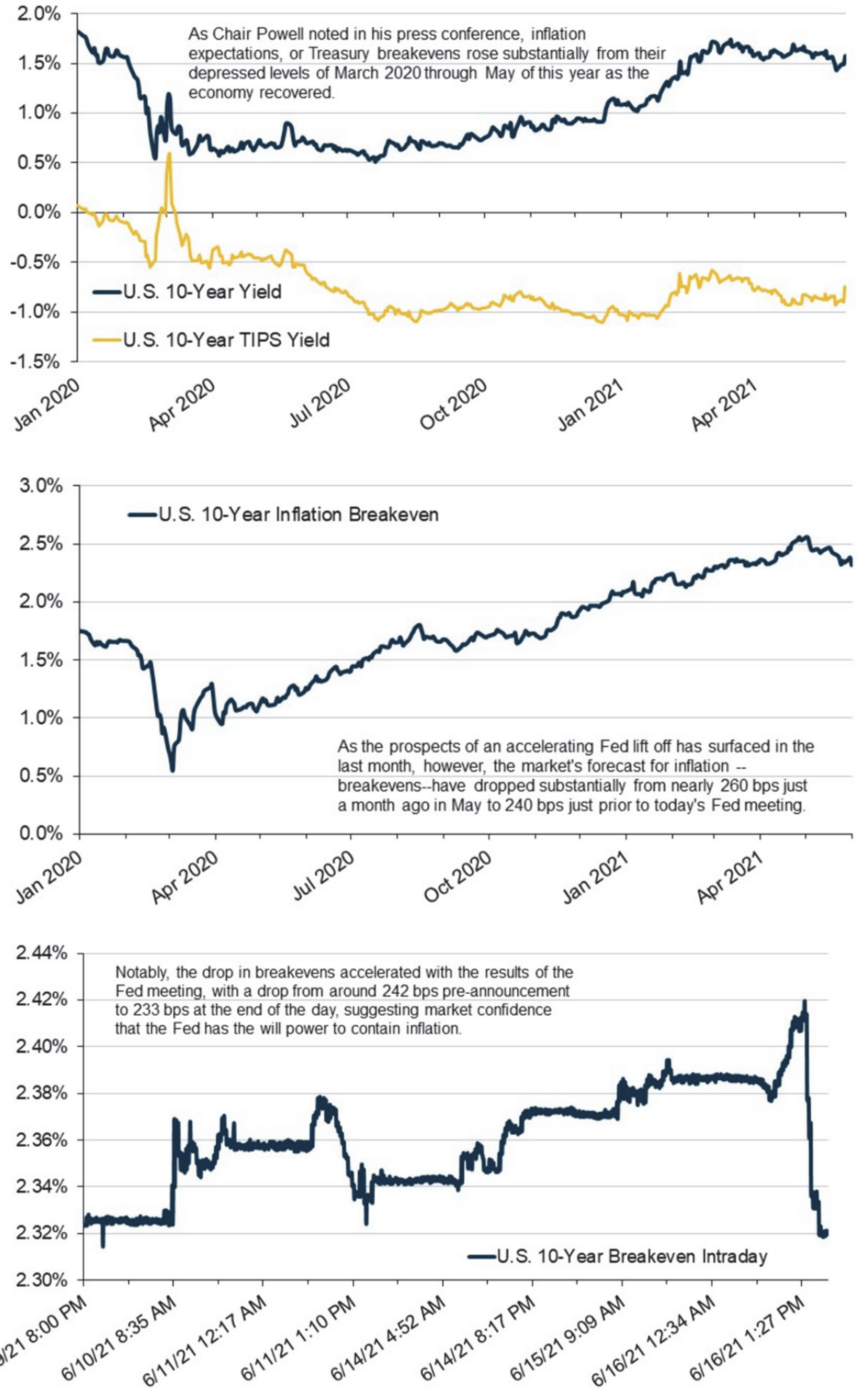
For more than a year, COVID-19 concerns have dominated risks to the economic outlook. At this point, though, the pandemic has thankfully receded to being just one risk among many, and FOMC participants now view risks to GDP growth as more balanced. The Fed’s updated assessment of inflation risks, though, was pushed higher. Powell noted the uncertainty now posed by the shortages and bottlenecks and the difficulty in estimating exactly when they will be solved, and price pressures thus alleviated. So, while inflation expectations currently appear to be well-anchored, for the Fed, there is a risk is that persistently higher inflation could translate into higher inflation expectations and become self-fulfilling. The Fed’s base case remains, though, that these supply shortages and attendant price pressures will subside.

We continue to think the Fed will be ready to taper its QE purchases by the end of this year. However, that requires continuation in the economic recovery and importantly, further strengthening in the labor market. We also expect that rate lift-off is likely to occur by the back half of 2023, so we broadly agree with what the Fed laid out in its latest projections and commentary.

The Implications of the “Real” World Moves

While the Fed’s actual changes in policy can adjust to the recovery’s progress, searing hot growth and soaring inflation is keeping the markets on edge. Against that backdrop, today’s message of sooner and steeper rate hikes embedded in the Fed’s dot plot understandably drove a selloff in the bond market. However, within that reaction two wrinkles are worth a pause to evaluate. **First**, the rise in real rates was much larger than the rise in nominal rates. For example, the 10 bp increase in the 5-year benchmark Treasury yield was topped by a 17 bp increase in the 5-year TIPS (real) yield, with the 7 bp difference representing the market’s decreased inflation expectations. So yes, the market expects the Fed to raise rates more and sooner, but it also expects inflation to be pushed down as a result (Figure 1).

FIGURE 1: THE MODERATION IN INFLATION EXPECTATIONS CONTINUED WITH THE LATEST FED MEETING



Source: PGIM Fixed Income, Bloomberg as of June 6, 2021.

Second, while the expectation for a more hawkish Fed pushed intermediate Treasury yields substantially higher, the same was not true at the back end of the yield curve. At the 30-year point of the curve, for example, the 6 bp increase in the TIPS real yield was almost entirely offset by a 5 bp decrease inflation expectations (breakevens), leaving the benchmark 30-year Treasury bond yield up just 1 bp. So, while the recent stronger growth and inflation prints are pulling forward expectations for a policy tightening, the market continues to appear confident that, over the long term, the Fed will be able to manage the situation with little net effect on the economy, hence the minimal net impact on long bond yields.

A Taper Tantrum Doled Out in Baby Steps

All said, the potential for a quicker Fed tightening path put a damper on risk appetite, as witnessed by the drop in stock prices, widening credit spreads, and a flight-to-quality bid pushing up the U.S. dollar. While these moves could continue a bit further in the weeks ahead—i.e. some further increase in short and intermediate term rates and weaker risk markets—several reasons remain for maintaining a relatively constructive view on both fixed income spread product and the overall level of rates.

First, the Fed's cautious approach should minimize the odds of a hard landing and maximize the odds of a long and moderate expansion. **Second**, the selloff in Treasury yields since March 2020 has already left a substantial buffer—a "pricing in"—of Fed rate hikes, giving us reason to believe that any further selloff in Treasuries should be limited.

In summary, given the upward surprise in growth and inflation numbers resulting from the COVID recovery and powerful fiscal stimulus, the Fed's pulling forward of its expected timing for rate hikes seems fitting. But in terms of the market outlook going forward, we continue to think that rates are likely to peak around mid-year—if they haven't peaked already—as they price in the recovery and the prospects for Fed normalization. Looking further ahead, by contrast, we believe the reversion towards more moderate growth and inflation in the years ahead is not priced into the market, suggesting that as the growth and inflation crest this year, longer-term yields are likely to modestly decline, boosting bond returns, and fueling an ongoing search for yield in fixed income.

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