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# The Fed Is Probably Done Hiking Rates, They Just Can't Tell Us Yet

By: Andrew Szczurowski, CFA | November 28, 2023

## KEY POINTS

1. In our view, the Federal Reserve (Fed) has to project a hawkish position on rate hikes to manage expectations and pave the way for eventual monetary easing.
2. Slowing inflation and the weakening labor market are signs that the Fed's past rate hikes are working.
3. Investors should ignore the noise coming out of the Fed and focus on the turning tide of U.S. economic data.

**Boston** - There is a constant debate among some Federal Reserve Open Market Committee (FOMC) members about where the terminal federal funds rate sits in this cycle and, perhaps more importantly at this point, how long the rate will stay at that level. While it may seem counterintuitive, we believe the Fed's quickest path to cutting the policy rate is to operate as if there is potential for more hikes.

In short, for the Fed to accomplish its objective of pushing inflation back toward 2%, policymakers have to set a narrative and stand by it.

## Managing expectations

Sometimes the market believes that narrative and other times it doesn't. When market views diverge widely from Fed guidance, the Fed needs to step up to manage market expectations. If the Fed is unconvincing, financial conditions within the market could begin to loosen and work against the plan to lower inflation. In this case, influencing financial conditions (e.g., higher bond yields, wider credit spreads, lower stock prices) is a key tool the Fed uses to fight inflation since it can temper consumer and corporate demand and ultimately reduce inflationary pressures.

Long-term investors have to separate the narrative from the eventual reality when it comes to "Fed speak." In the short term, however, narratives can be very powerful in markets. For instance, when the Fed released a new dot plot after the September FOMC meeting, a substantial bond market sell-off ensued because the Fed's year-end 2024 federal funds rate projection jumped from 4.645% to 5.125%.<sup>1</sup>

At the time, the Fed was not pleased with risk markets and the bond market ignoring its threats to hike rates further, so it needed to reassert the narrative by using a stick (dot plot) to get markets back in line. In reality, the Fed doesn't know where the federal funds rate will sit in 14 months and they certainly will not feel obligated to stick to that earlier dot-plot forecast.

On this point, a walk down memory lane to March 2021 is illustrative. The Fed's dot plot back then projected zero rate hikes until 2024! By mid-2023 the rate rose to 5.5%. At the time of the projection in 2021, the Fed was trying to keep financial conditions as loose as possible to slingshot the U.S. economy out of the pandemic-induced recession and used the dot plot to set a narrative that they would be easy for years to come.

## Investor implications

For investors, the Fed's approach implies that the road to rate cuts will be paved with hawkish commentary that prevents a straight downward line in yields. Thus, if bond yields continue to rally, we will see more hawkish Fed speak, as policymakers try to coax financial conditions tighter. Conversely, a substantial bond sell-off, would provoke the opposite response from the Fed. We saw this scenario play out a few weeks ago, after U.S. Treasury yields rose more than 100 basis points in a short period of time, spooking a number of FOMC members enough to say they felt they had likely reached their terminal rate.

When investors parse through the noise and look at the general trend of slowing inflation and a weakening labor market, the signs are clear that the Fed's rate hikes are working. The lags with which monetary policy filtered through were just longer this cycle. Consumers and corporations were prepared for tightening, given that we came from the zero lower bound and they were able to term out their debt at once in a lifetime levels.

If the Fed is in fact done hiking rates for this cycle, as we believe, longer-term investors, who can look through the short-term noise, will be presented with compelling opportunities in fixed income, with less tail risk than we had over the past year. It means that bond investors now have more clarity on the front-end rate with which to bootstrap off of the rest of the treasury curve.

Still unclear for investors is what the future term premium will be as bond investors go further out on the Treasury curve. It also means that investors who are part of the \$6 trillion sitting in money markets or investing in T-bills will no longer be able to roll into higher yields, as they will start getting less yield in the coming months. If this begins to happen, you will likely see an exodus out of T-bills, looking to move out the

risk and interest rate curve and lock in today's yields for as long as possible.

**Bottom line:** Investors should ignore the noise coming out of the Fed and focus on the turning tide of U.S. economic data. It is important to remember that the bond market is forward looking and takes an escalator up in yields and an elevator down. If investors sitting in cash wait for rate cuts to begin reallocating out the interest rate curve, they will likely miss the opportunity.

<sup>1</sup> Source: Bloomberg. As of November 17, 2023.

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