Rates Policy & the Fed

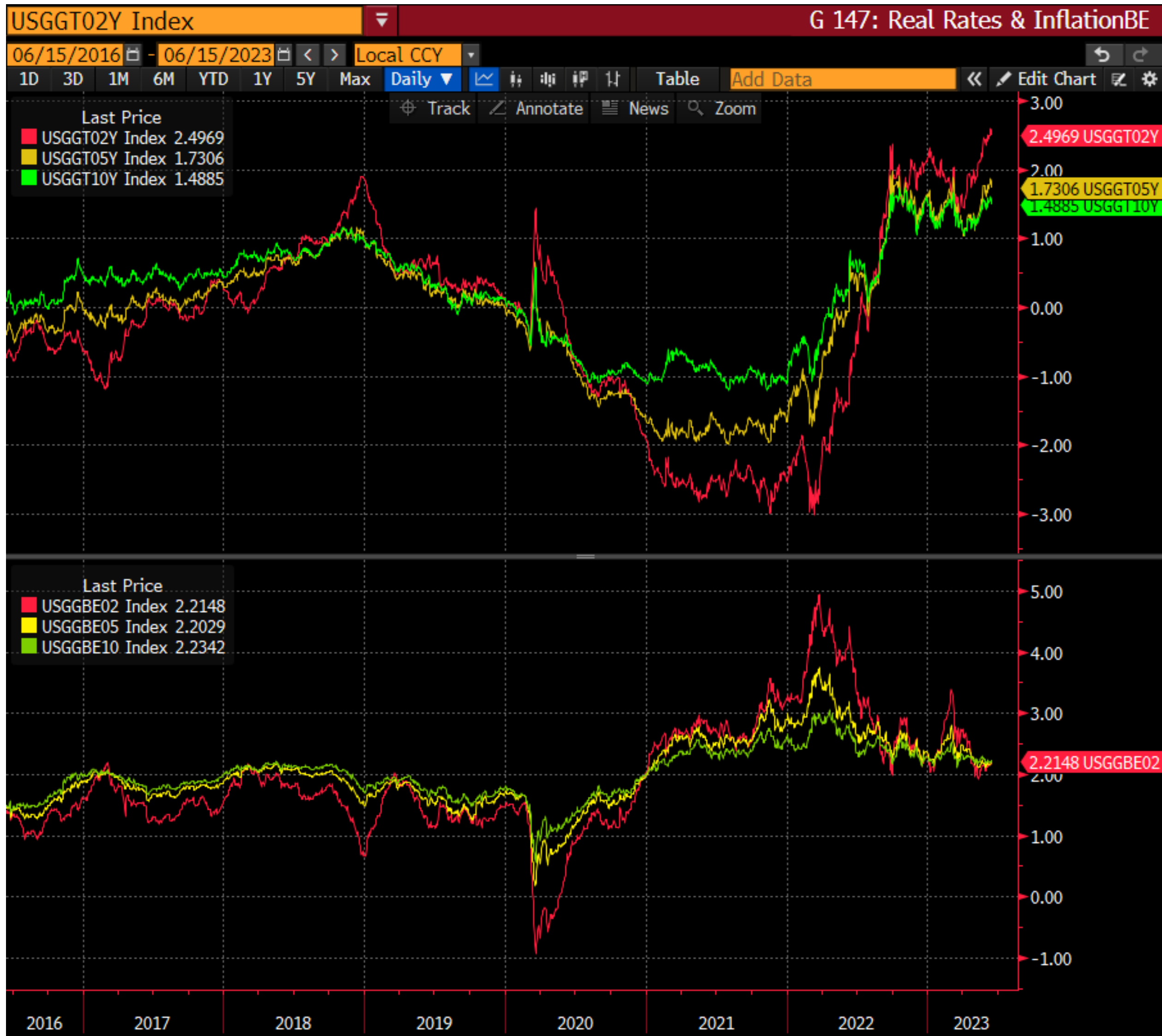
"Should I Stay or Should I Go?"

Background:

After ten sequential moves higher, the Fed decided not to raise rates at its June meeting. The language of the FOMC statement was changed to strongly suggest that there will be another hike coming and the Dot Plot suggests that two more hikes may be coming based on the median target funds rate for 2023 jumping 50bps to 5.625% (note that the distribution for this median still implies more risk of a lower policy rate than a higher policy rate by 2:1). The Fed is not only the master moneychanger, but also the master messenger -- **the key message from the June meeting was policy should be "higher for longer"**. Indeed, the hawkish intent of elevating the dots over the next two years was to persuade markets that the Fed is serious about keeping rates elevated for an extended period so lag effects from market adjustments can do the inflation fighting in advance; and as markets fight in advance, the action messaged may never be needed. So, the debate that follows the meeting is not as much over how high the federal funds rate will go, but how long they will stay at where they end up; and how fast they will ease the funds rate back down when inflation wanes – and we are confident that inflation will wane (see Observations; Why all this matters). Essentially, if you are Chairman Powell thinking about the next policy move in July the question is, **"Should I stay or should I go?"** It is a good bet that Powell will go up at least one more time because the gap between the lower bound of target funds rate (5.0%) and the core personal consumption deflator (4.7%) is 30bps and a move up in rates is a sure way to widen the gap now that it is in a downward trend – a more positive real federal funds rate is more insurance to create the needed friction to slow demand to wane inflation or foster disinflation.

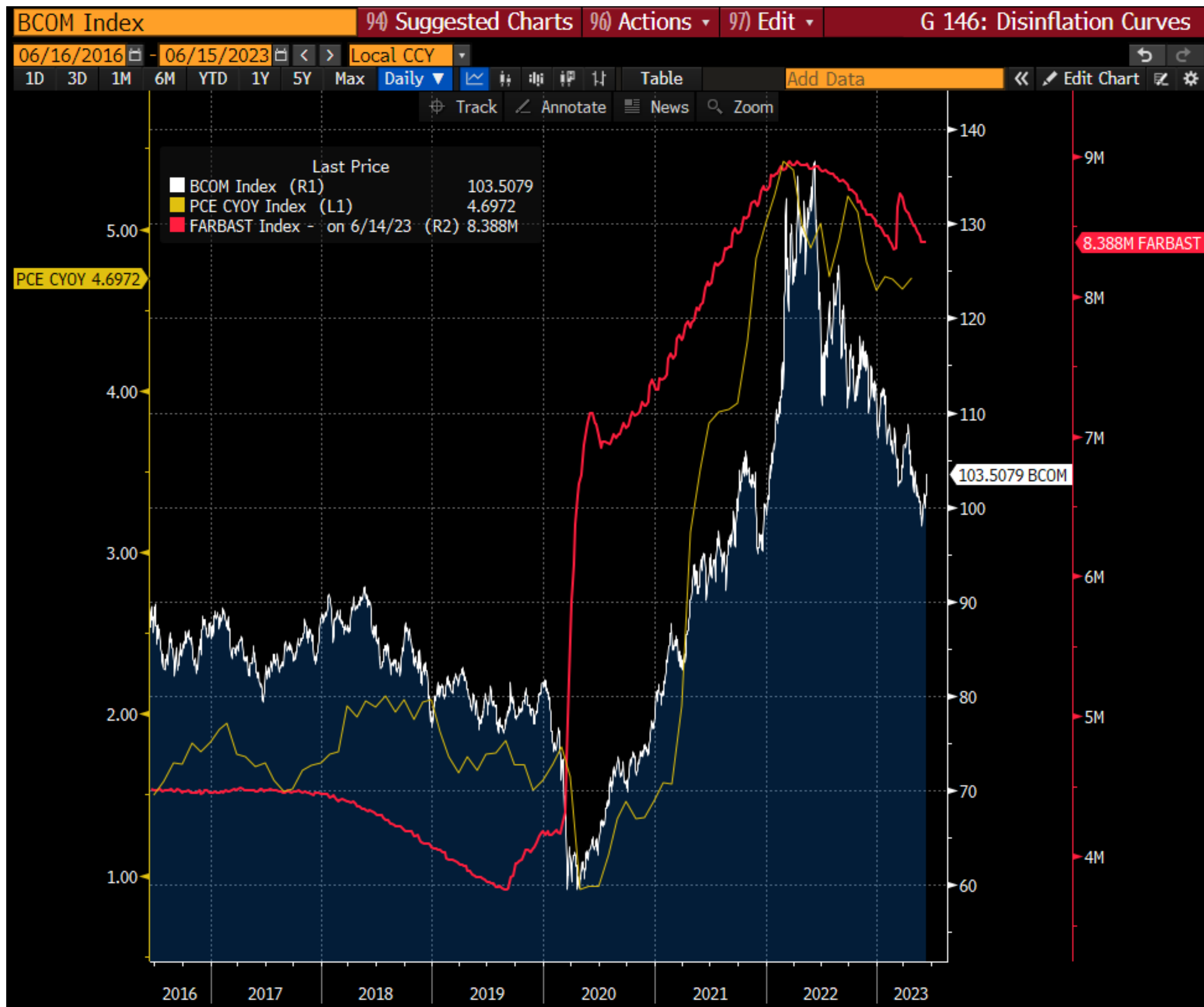
Observations:

Real rates are reaccelerating higher given the Fed's recent policy message because breakeven inflation rates are coming down toward the Fed's long-term goal of 2%. See the chart below:



Source: Bloomberg

The top panel shows US Treasury Inflation Protection Securities (TIPS) which are real rates; and as real rates are rising. As real rates are rising the US Treasury market's view on inflation is falling – "breakeven UST inflation rates" are shown in the lower panel. The graph below shows that commodities prices are falling and the core personal consumption deflator is falling too:



Source: Bloomberg

The BCOM is Bloomberg's commodity index and the PCE CYOY is the year-over-year core personal consumption index (the Fed's preferred gauge of inflation). The red line is the Fed's balance sheet which is being reduced by about $90bil./mo. – the recent spike in the Fed's balance sheet reflects borrowings from the Fed's Bank Term Funding Program (BTFP) to provide liquidity for deposit withdrawals, but this should reverse when the borrowing banks get the par run-off from their liquidity portfolios. Nonetheless, balance sheet trend is still declining.

Why all this matters:

The growth and decline in the Fed's balance sheet is positively correlated to inflation trends with about a 4-6month delay. The recent spike indicated a net reduction in bank deposits (i.e., because takedowns from the BTFP are rising), which alone is a strong recession indicator -- or at a minimum a significant drag on economic activity. So, the Fed knows than inflation should be waning and that either another rise in the funds rate or a further fall in the core PCE will widen the gap more – keep in mind that the Fed paused last time (i.e., the summer of 2019) when this gap was 60bps and during a time when the Fed was continuing to reduce its balance sheet like it is now. The next PCE report is on June 30th and the next FOMC decision is on July 26th so there is plenty of time (opportunity) for the data to either support a stop, pause or another insurance hike to widen the gap.

Bottomline:

If the Fed is not done raising rates, most of the market's job should be complete, nonetheless. The Fed's ongoing balance sheet reductions are the backstories creating friction to aggregate demand while the rate hikes are getting all the headlines. May was the 11th straight month of declines in the producer price index so the balance sheet reduction's lagged effects are gaining momentum. Indeed, even though Chairman Powell says, *"It will be appropriate to cut rates at such time as inflation is coming down really significantly and we're talking about a couple of years out",* bond markets (i.e., hybrids) should rally in advance of that cut which means they should be in a rally trend during the extended period when the Fed has "stopped" (which is either now or beginning next month most likely). There are attractive yields available in hybrid preferred securities which offer significant yield advantages to corporate bonds, shown here:

	A	B	C	D=B/C	E=D/A
Purchasing Power Matrix: Financials	Mdur	YTW%	5yrBE Inflation%	Inflation Coverage	Inflation Coverage/ Mdur
Retail $25par (p0p4)	13.00	6.92	2.21	3.13	0.24
NoCos (stb8)	3.91	7.63	2.21	3.45	0.88
CoCos (cdlr)	2.60	8.37	2.21	3.79	1.46
More Sr. Fins (e0ba)	4.85	5.63	2.21	2.55	0.53

Source: Bloomberg; ICE BofA Bond Indices

If the most highly anticipated recession does come, we expect hybrids to do better than high yield bonds because the refunding cycle during a period of elevated intermediate rates could pressure high yield EBITDAs and interest coverage during a time when unit sales are slowing too – this would not be a good combination for high yield credit quality. Ironically, some sector credit instability could perhaps even be somewhat "welcomed" by a Fed so determined to see inflation come down "*really significantly*". We believe **now is the time to be buying junior subordination in quality financials** despite money market returns appearing so attractive because by the time these short rates come down, prices on term spread product should have already made a good move higher – so, **lock in the total returns now while there is some time and attraction** as headlines focus on rates or Powell's dilemma of "should I stay or should I go?" rather than the cumulative disinflationary momentum of the balance sheet reductions evidenced by the slower UST breakeven inflation rates. Furthermore, the spread between high yield bonds and junior subordinated capital securities is just about as tight as it's been in 5yrs (i.e., about -1.4 stdevs tight of average) which makes allocating to hybrids rather than high yield quite compelling given the very tight yield give-up to sell high yield bonds to buy hybrids.

Phil Jacoby
CIO, Spectrum Asset Management
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