SKY HARBOR
CAPITAL MANAGEMENT

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SKY Harbor Weekly Briefing

SKYView: Debating the Neutral Rate

The highly anticipated May ’22 FOMC meeting has finally come, with the Fed raising short-term rates by 50 bps, the most aggressive increase in over two decades. On balance, Chairman Powell’s comments were quite measured, highlighting risks associated with inflation but also, at least initially, calming market fears of a looming recession. In this *Weekly Briefing*, we highlight the key aspects of the post-meeting press conference, and take a closer look at the impact a higher “neutral” level of interest rates may have on underlying Treasury yields.

While raising rates by 50 bps (the most aggressive such move since May 2000) and conceding that “inflation is much too high,” Fed Chairman Powell appeared to strike a modestly more-dovish-than-expected tone this past Wednesday, **most notably by stating that a 75 bps rate hike is not being actively considered by the committee** (a 75 bps hike was beginning to be priced into market levels for June). Furthermore, Powell’s plan for reducing the size of the balance sheet – which has ballooned to nearly $9 trillion – was a bit milder than anticipated, with the chairman ultimately calling for a more gradual than feared ramp to $95 billion per month. Finally, Powell noted that the US economy remains strong, that he does not expect to see a wage-price spiral, and that labor markets remain tight but inherent resiliency is supportive of a soft landing.

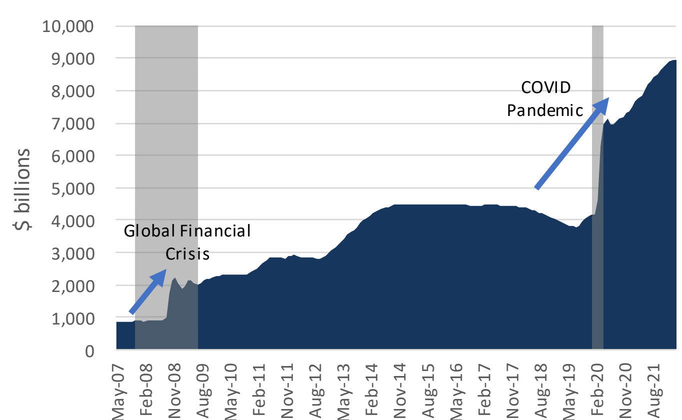
May FOMC Meeting Takeaways

from May 4, 2022 press conference

- 50 bps rate hike, the first of this magnitude since May 2000 (brings Fed Funds target rate to a range of 0.75% - 1.00%)
- Hikes of this magnitude are likely to occur in the next "couple" of meetings, but a 75 bps hike is not currently being considered
- The committee recognizes that inflation is "much too high," but they have the tools to lower it; moving "expeditiously" to bring inflation down
- The Fed will begin to trim the $9 trillion balance sheet; beginning June 1, they will begin to roll off $30bn of Treasury securities and $17.5bn of mortgage-backed securities per month; will rise to $60bn and $35bn, respectively, per month after a three month period
- Economy remains strong, labor market remains tight
- The 50 bps hike was a unanimous decision by the committee

Federal Reserve Balance Sheet

monthly data, trailing 15 years; recessions shaded grey

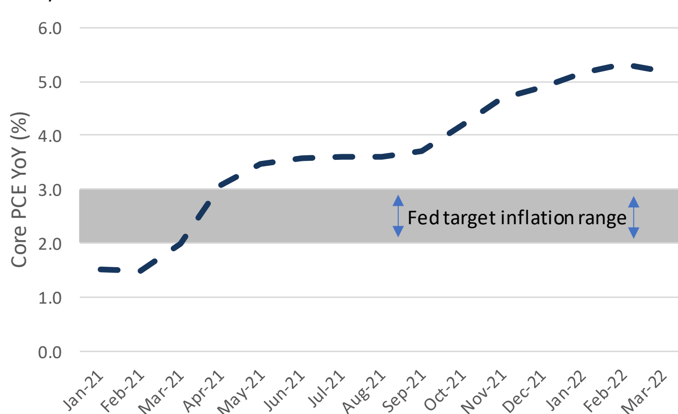


Source: SKY Harbor, Board of Governors of the Federal Reserve System, National Bureau of Economic Research

First, the good news. **US Core Personal Consumption Expenditure, the Fed’s favored gauge of inflation, remains highly elevated but has perhaps come close to peaking** (the measure actually decelerated to 5.2% in March, down 10 bps sequentially, with even more significant easing found in the Dallas Fed’s trimmed-mean index price[1]). Though likely to remain well above the Fed’s target range of 2.0% - 3.0% in the coming quarters, base effects, readings of consumer sentiment, and signs of some alleviation in transportation costs point to the start of normalization this summer. At the same time, **the 2s/10s curve continues to steepen, up over 35 bps since (near) inversion just over a month ago** (for more information, see our prior *Weekly Briefing* entitled “Yield Curve Inversion”).

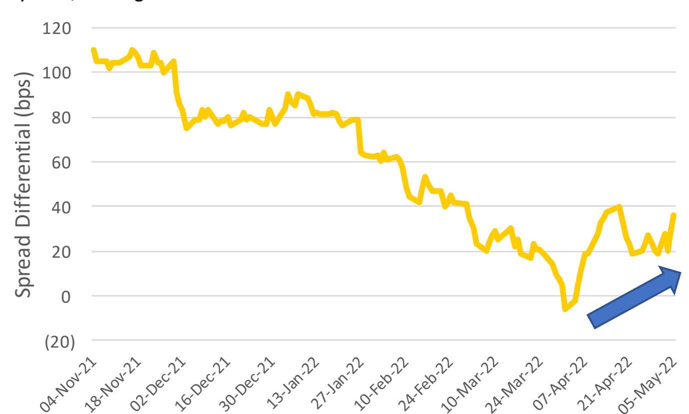
Fed's Favored Metric for Inflation High But May Have Peaked

monthly data



2s/10s Have Steepened After Near Inversion Several Weeks Ago

daily data, trailing 6 months



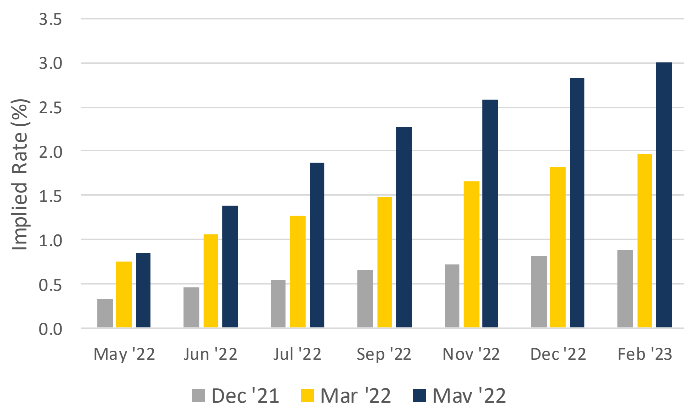
Source: SKY Harbor, Bureau of Economic Analysis, Bloomberg, ICE Data Indices

[1] https://www.dallasfed.org/research/pce

The more hotly debated topic arising from the meeting, however, is the so-called "neutral" level of interest rates. This level – a long-run target at which rates neither boost nor constrain the economy – has often been estimated to be ~ 2.4%, but can fluctuate rapidly depending on economic conditions. **With the Fed having previously expressed a desire to move toward a more neutral policy level "expeditiously," the market-implied pace of hikes ratcheted up materially (left chart below) over the last several months** (see our recent *Weekly Briefing* entitled "The Rise of FX Hedging Costs" for more details on how expectations have evolved since the start of 2022). At present, markets are pricing in an implied rate at or modestly above long-term "neutral" by Q4'22, with yields on 5-year treasuries – based on a highly correlated time series presented below (right side) – rising sufficiently to incorporate that view. The risk to underlying rate volatility, however, stems from the possibility that the Fed will need to overshoot the long-run neutral level in a bid to curtail inflation, perhaps by a significant amount.

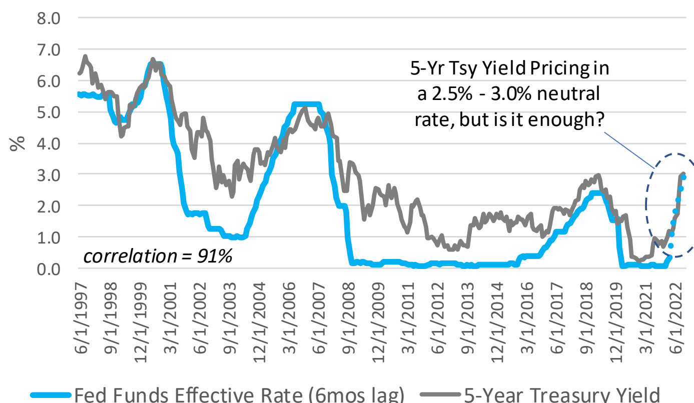
Market-Implied Fed Rate Hiking Path Has Accelerated

Fed Funds Futures Implied Rates



2% to 3% "Neutral" Rate Already Priced in by 5-Year Tsy Yield

market-implied expectations = dotted lines

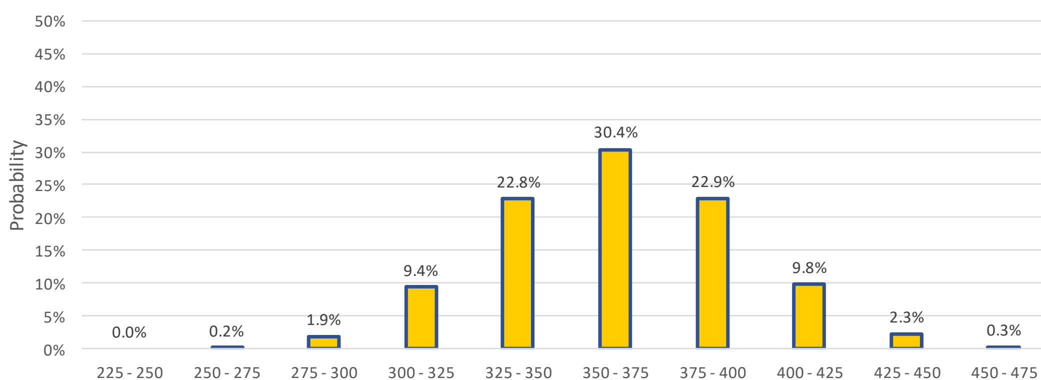


Source: SKY Harbor, Bloomberg, Federal Reserve Bank of New York, ICE Data Indices

According to the CME FedWatch Tool, **target rate probabilities now point to a range of 3.50% - 3.75% by the July '23 FOMC meeting date, implying the need to temporarily overshoot the commonly estimated level of "neutral" by over 100 bps as a result of inflation running well above the Fed's 2% target**. Economists at Harvard University[2] and Dartmouth College[3] have recently speculated the Fed may need to be even more aggressive, perhaps raising rates to 5% or more in order to get the inflationary environment under control. If this were to occur, the dramatic selloff in treasuries experienced year-to-date may only be slightly more than half of the adjustment necessary.

Target Rate Probabilities - July '23 FOMC Meeting

data as of May 5, 2022



Source: SKY Harbor, CME FedWatch Tool

We saw very little in the way of surprises at the May FOMC meeting, with – if anything – a slightly dovish tone emerging (the 50 bps move was unanimous, as even Bullard did not dissent, and a 75 bps hike was deemed not under consideration at present). Inflation, however, remains a real concern, with the path to a soft landing becoming narrower as additional pressures mount (Ukraine, China, etc.). Going forward, we expect underlying rate volatility to remain elevated, particularly as the market sorts out the likely magnitude of "neutral" sufficient to combat rising prices in the near term. With that said, the embedded credit risk component of high yield bonds should provide some protection against rates, with any sustained sign of peak inflation likely to provide support for the asset class.

[2] https://www.bloomberg.com/news/articles/2022-05-03/rogoff-sees-fed-hiking-rates-up-to-5-as-things-out-of-control

[3] https://www.marketwatch.com/story/powell-wants-to-get-closer-to-neutral-but-whats-that-think-between-5-and-6-former-top-fed-staffer-says-11651566417

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