SMITH CAPITAL INVESTORS

Mismatch between Fed and Market

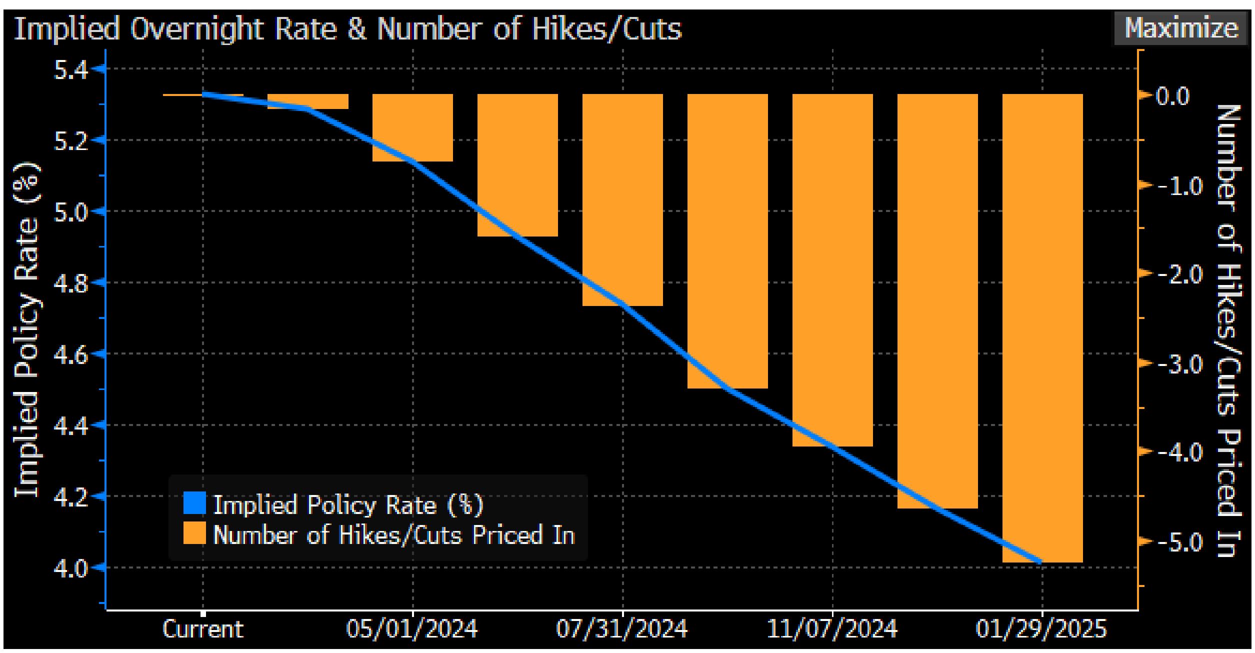
The omnipresent battle between the Fed and market expectations continues to wage after the January FOMC meeting, despite explicit commentary from Powell pushing back against the likelihood of the rate cut cycle beginning in March. It wasn't until a strong January NFP report surpassed all estimates that market expectations started to become more in line with the Fed. Even so, the market is still not fully aligned with the view that the Fed can remain on pause for longer to ensure continued progress on reducing inflation is achieved.

The FOMC held their policy rate in a range of 5.25-5.50% at their January meeting, but language was altered in the statement to acknowledge that peak rates have been reached. The timing and cadence of rate cuts will be dependent on greater confidence around sustained downward progress on inflation. The committee, however, is in no hurry to begin the easing cycle. Given the strength of recent economic data, our view is that the Fed can be patient and will likely deliver fewer rate cuts than expected by the market amid a strong labor market and softer (but still positive) U.S. economic growth.

The January FOMC statement revealed there is no longer a tightening bias among committee members, but they will not look to reduce the target range until there is greater confidence around inflation returning to the 2% target. Powell mentioned in his press conference that recent data have created confidence in a downward trajectory, but a few more months are likely required to confirm the trend before easing. Leading up to the January meeting, markets were optimistic about March being the start of the easing cycle, with approximately 150bps of total cuts priced in for 2024. After Fed pushback and strong economic data, Fed Funds Futures pared some of the previous optimism, and probabilities of a March cut were trimmed to about 17%, alongside fewer than 125bps of total cuts in 2024.

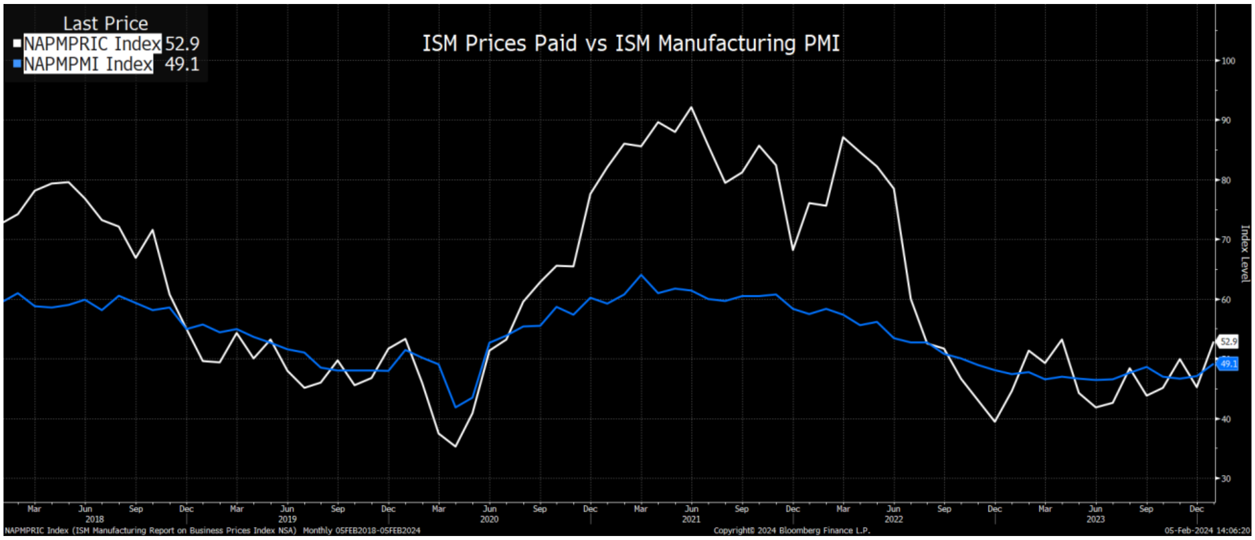
Region: United States »		Instrument: Fed Funds Futures »	
Target Rate	5.50	Pricing Date	02/05/2024
Effective Rate	5.33	Cur. Imp. O/N Rate	5.324

Meeting	#Hikes/Cuts	%Hike/Cut	Imp. Rate Δ	Implied Rate	A.R.M.
03/20/2024	-0.174	-17.4%	-0.044	5.280	0.250
05/01/2024	-0.764	-59.0%	-0.191	5.133	0.250
06/12/2024	-1.602	-83.8%	-0.400	4.923	0.250
07/31/2024	-2.365	-76.3%	-0.591	4.733	0.250
09/18/2024	-3.305	-94.0%	-0.826	4.498	0.250
11/07/2024	-3.947	-64.2%	-0.987	4.337	0.250
12/18/2024	-4.640	-69.2%	-1.160	4.164	0.250
01/29/2025	-5.255	-61.5%	-1.314	4.010	0.250



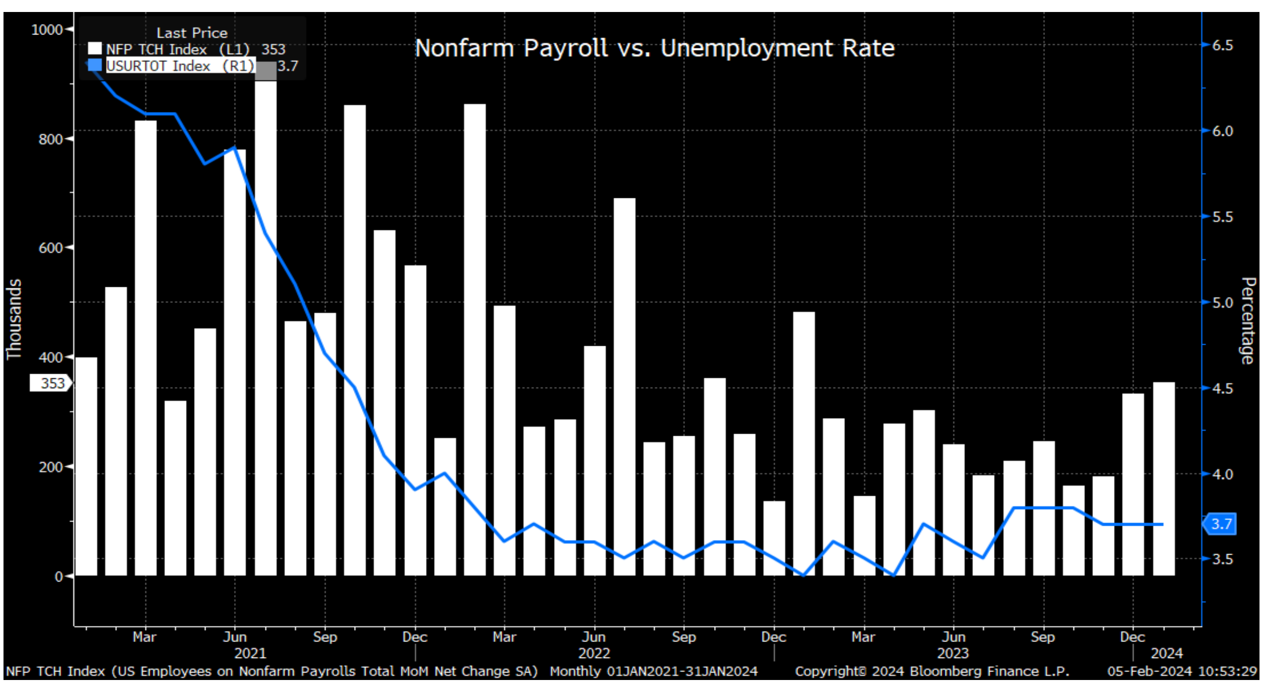
Source: Smith Capital Investors, Bloomberg 2/5/2024

One of the main drivers behind our view that the Fed can stay on hold longer and ease less than the market is expecting is due to the strength of the incoming economic data. 4Q GDP growth was strong, the labor market continues to be healthy, and ISM manufacturing, which has been weak since 2022, is showing signs of recovery.



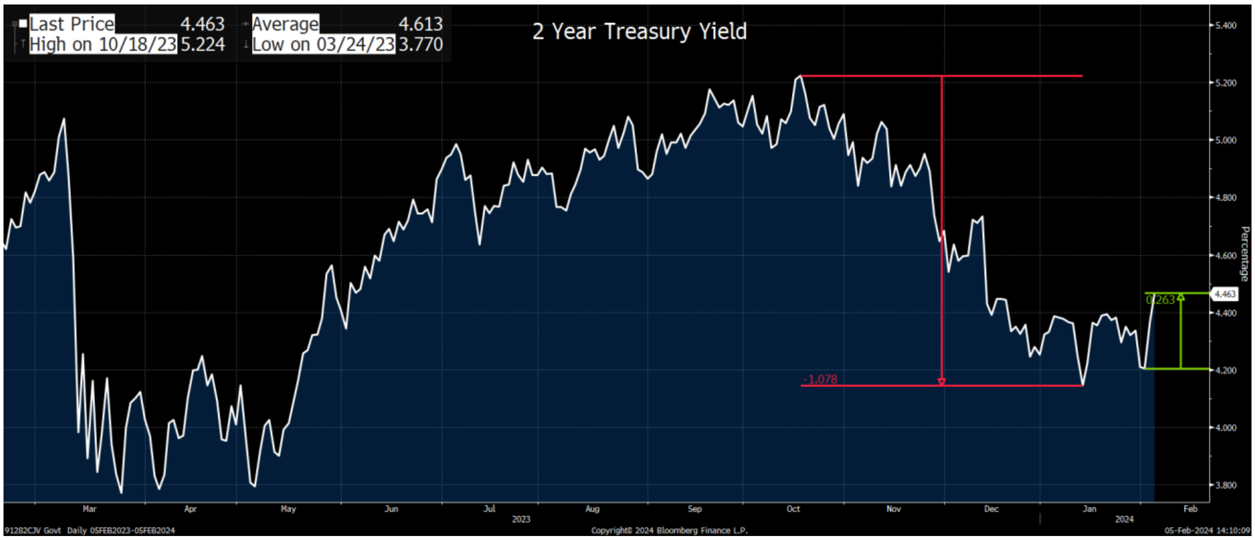
Source: Smith Capital Investors, Bloomberg 2/5/2024

The January Nonfarm payrolls headline beat and accompanied revisions highlighted that the strength of the labor market was greater than expected through the 2nd half of 2023 and remains resilient to start off 2024. Gains were broad-based across sectors, and wage growth posted outsized growth that came in well ahead of estimates. A tight labor market provides the foundation for sustained economic growth despite higher rates and allows the Fed more security to focus on the inflation aspect of their dual mandate. This drives our view that the Fed can remain on hold for longer to ensure that inflation is on a sustained path downward before easing monetary policy.

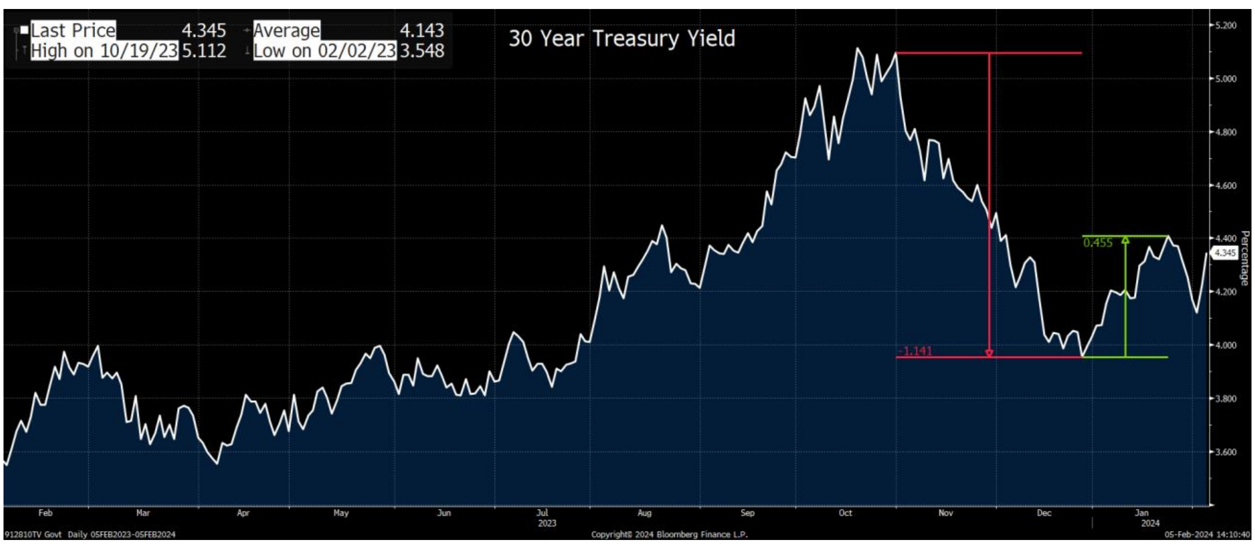


Source: Smith Capital Investors, Bloomberg 2/5/2024

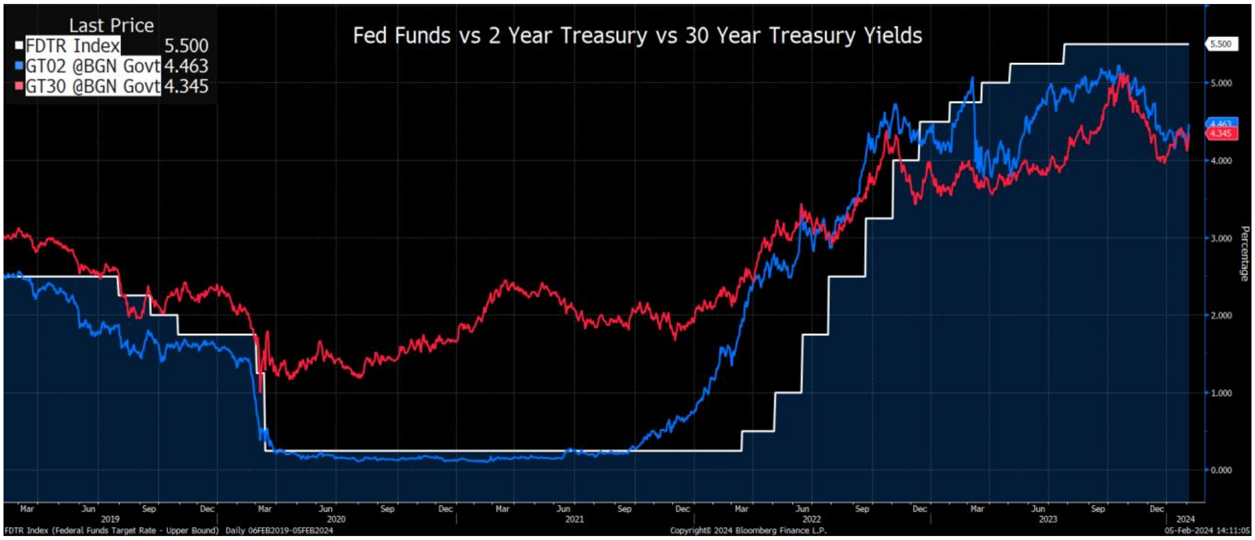
After the Fed signaled their dovish pivot in December, market euphoria drove a swift rally across multiple asset classes under the assumption that rate cuts are imminent, and the proverbial soft landing would be achieved. While rate cuts are still in the Fed's forecast, our view is that markets have run too far too fast. Barring a major risk event, the Fed won't be in a position where it has to cut as quickly or as aggressively as the market wants. After a 100bps rally, the front end of the treasury curve will likely need to adjust higher to accept this reality, while the long end will conceivably be range-bound given the further progress necessary on inflation amidst a strong economic foundation.



Source: Smith Capital Investors, Bloomberg 2/5/2024



Source: Smith Capital Investors, Bloomberg 2/5/2024



Source: Smith Capital Investors, Bloomberg 2/5/2024

We anticipate that the enduring conflict between the Fed and market expectations will continue to produce bouts of heightened volatility, but as we rationalize a path forward, we understand that curve normalization is unlikely to occur in the near term. A prolonged 2s/10s inversion is likely to persist under current conditions until one of two circumstances materialize: a crisis threatens economic stability, and the front end falls dramatically on expectations of swifter rate cuts, or inflation remains elevated, and the long end responds to accept higher rates for longer. Even in the latter scenario, long-end rates are likely bound below the highs marked last October based on encouraging inflation data over the past few months. With respect to the present situation, however, the Fed does not need to cut aggressively (125+ bps of cuts priced in) or with any urgency given the strong economic backdrop under which the U.S. economy continues to operate. Powell mentioned during his press conference and his interview on *60 Minutes* that the Fed's work on inflation is "not yet finished", and the committee will not likely gain the confidence needed to begin lowering rates until that trend is confirmed by a few more months of good data. The Fed's stance on Quantitative Tightening (QT) has not altered significantly but will be an area of focus for committee members and investors at the March meeting. Under the assumption that the Fed will not deviate dramatically from this view, over-bought conditions in the front end of the curve will need to reprice higher to accept that the timing and cadence of rate move expectations were overly aggressive coming into 2024. While curve inversion will likely persist in the interim, we will continue to be agile with respect to curve positioning to take advantage of continued volatility in markets.

Let’s keep talking!

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