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MARKET UPDATE

Fog is clearing, but more hurdles are ahead

An optimistic start to 2023?

While 2023 is still full of uncertainty, it is likely to be a less tumultuous year than 2022 as the Fed approaches the end of its tightening cycle and inflation continues to move in the right direction. Investors are much more confident in the outlook for 2023 than they were only a few months ago, though a possible recession on the horizon is keeping everyone on their toes.

The challenge for the Fed is the full effects of the 425bps of hikes they have implemented over the past 10 months have yet to be realized. It takes time for the tighter conditions to filter through the economy, generally 9+ months. As economist John Mauldin puts it, "It's a slow erosion as higher financing costs change consumer and business decisions. As time passes, more people see their debt servicing costs rise as rates reset to higher levels. That leaves less money for other spending—which is exactly what the Fed wants: lower aggregate demand." In order to avoid a recession, the committee needs to avoid overtightening, which means it likely needs to pause the rate hikes in the coming months to assess the economic impact.

The bond market rallied in January as economic data showed inflation continuing to cool, sending front end rates down 20bps+ and the tail of the curve down over 35bps. We are getting close to the peak rate for fed funds, with the market pricing in 2-3 more 25bp hikes the first half of the year before the Fed pauses/pivots.

We have talked about the Fed trying to thread the needle and tighten financial conditions enough to bring inflation back to the 2% range while not over-tightening and driving the economy into a recession. The fabled "soft landing". But how realistic is it at this point? Economist differ in their opinion, with about 60% projecting a recession this year.

Our base case remains a mild recession the second half of the year. The biggest factor is the rapid pace of tightening by the Fed, which has been the most aggressive tightening cycle since the early 1980s. Other factors include the inverted yield curve and a slowing economy.

The argument against a recession include a more balanced economy than a year ago that may be able to better absorb shocks, inflation continuing to move lower, and the possibility the Fed pivots sooner than expected.

Uncertainty from the Fed

The Fed has indicated that a mild recession is better than not curtailing inflation. However, they are still hopeful they can tame inflation without killing growth. But the central bank has their work cut out for them to accomplish this lofty goal. The last 5 times inflation peaked above 5% (1948, 1951, 1970, 1974, 1980, 1990, and 2008) the US subsequently entered a recession. The Fed appears to be as uncertain as the rest of the market on how both rates and the economy will fair in 2023. In March of last year, the committee projected fed funds to be 1.75%-2.00% at the end of 2022. We ended the year with the policy rate at 4.25%-4.50%, over twice the amount of tightening than initially forecasted.

Recent Headlines

Fed's Williams Says There's More Work to Do on Cooling Inflation

Bullard Says Fed Rates Need to Stay on Tighter Side in 2023

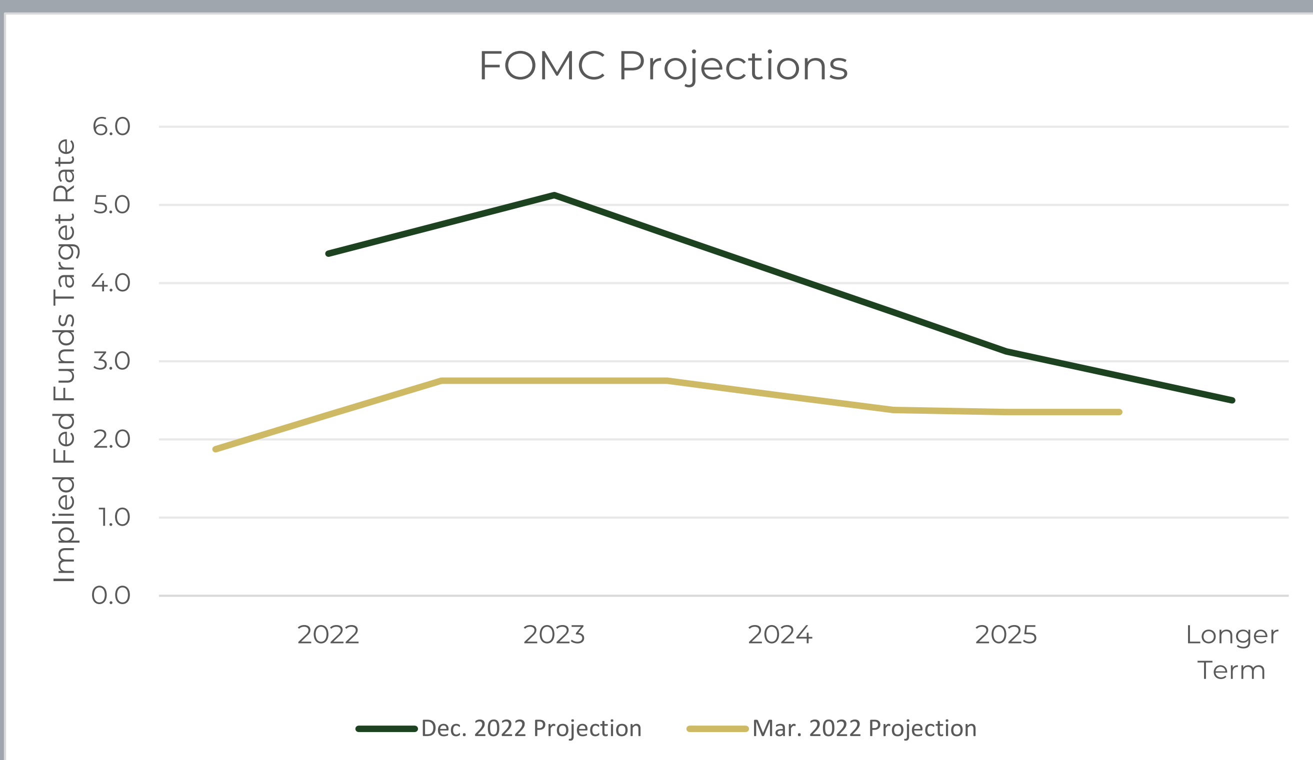
Fed's Bowman Says More Rate Hikes Needed to Curb High Inflation

Daly Sees Fed Raising Rates Above 5% But How Far is Unclear

Fed Officials Call for More Hikes Even as Price Pressures Cool

George Says Fed Should Hold Rates Above 5% Well Into 2024

Last month Chairman Powell said, "I just don't think anyone knows whether we're going to have a recession or not. And if we do, whether it's going to be a deep one or not ... it's not knowable,". We always appreciate candid comments like this from our Chairman. 'We are the ones setting rates, and damned if we know what's going to happen.' Thank you…we will take that over repeatedly telling us inflation was transitory or that the inflation uptrend has been driven by supply chain issues and has nothing to do with the central bank's own actions.



Opposing Views... From the Experts

The futures market (while never accurate, has a stronger track record for forecasting future rate levels than the US central bank) and the Fed do not agree the path for the fed funds rate moving forward. As of last month, 17 of the 19 Fed officials forecasted a peak rate of 5% or more, with NO members anticipating rate cuts this year. This would mean at least 75bp of further tightening, followed by an extended pause at the peak rate.

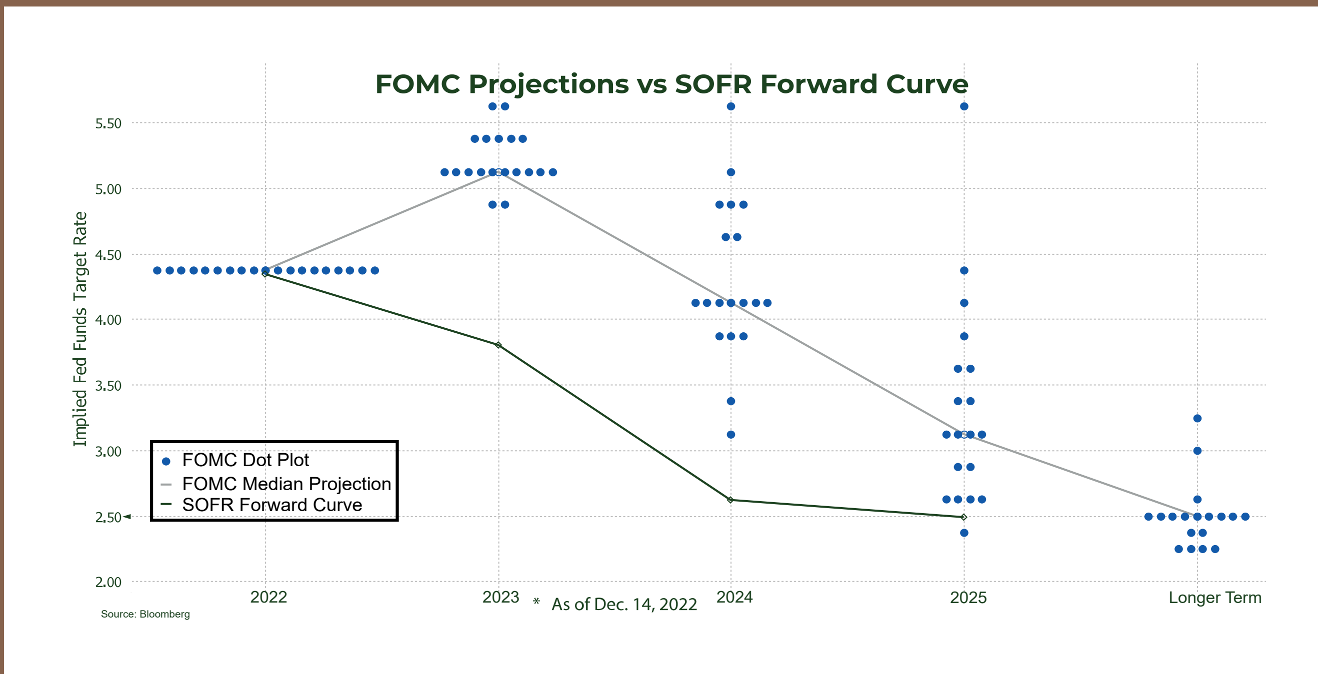


Chart Source: Bloomberg

The futures market on the other hand is pricing in about two more hikes, bringing fed funds to roughly 4.9%, followed by two rate cuts the second half of the year, putting fed funds back at 4.4%, where we started the year.

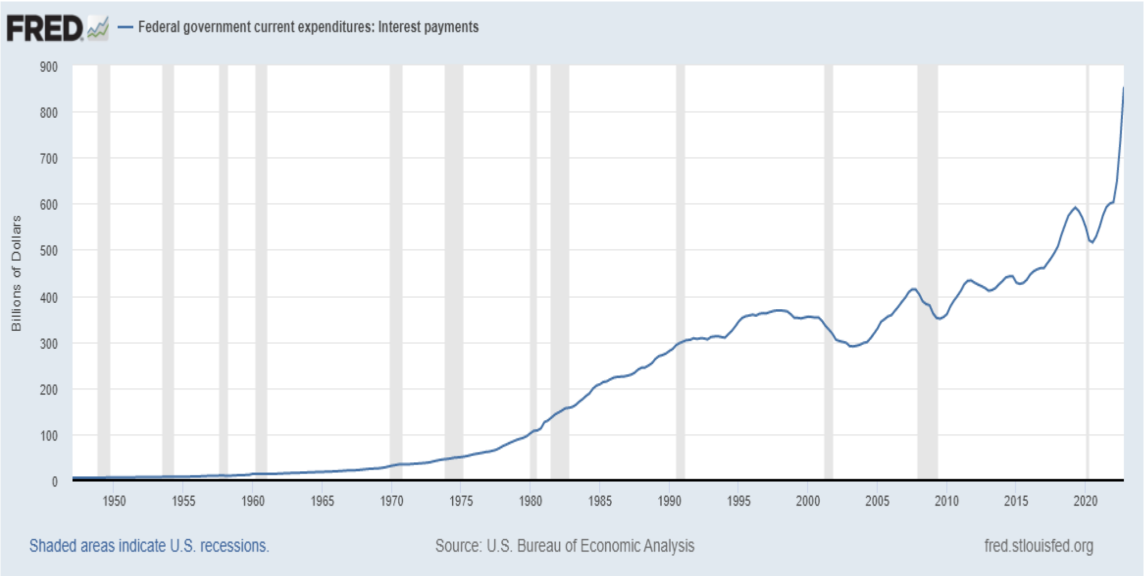
The disconnect between the Fed and the market represents the downside risk for floating rate borrowers. If Powell holds the line and does not cut rates this year, we will see short term rates move markedly higher as the market prices in a higher rate environment for a longer period of time.

We know the Fed is focused on curbing inflation, but most market participants have no real experience with an inflation spike. You are likely in your 60's if you were actively investing during the last inflation spike in the early 1980s… Whether you are an economist, analyst, or investor with 30 years' experience, your knowledge of a high inflation regime is academic at

The Debt Ceiling

One factor that is not supposed to be considered by the Fed, but certainly has Treasury Secretary Janet Yellen's full attention, is the debt ceiling. The US hit the $31.4 trillion debt limit on January 19th and Yellen has implemented measures to avoid default, such as suspending new investments in the federal retirement program. The debt ceiling issue is normally a bipartisan non-issue. For context, the debt limit has been modified 20 times since 2022, so it is essentially an annual exercise. The previous limit was increased by $2.5 trillion in December 2021.

But the thing to keep in mind is the impact a growing debt level has on interest payments owed by the US on Treasuries given the spike in bond yields. The interest expense on the current outstanding US debt is over $850 billion, which has more than doubled in the last 10 years. If the US budget deficit grows by $1 trillion and interest rates stay above 4%, the interest expense for the US is expected to top $1.2 trillion.



Hedging Costs

2-Year Cap Cost (bps)			
Strike Rate	1/27/2023	1 month ago	% Decrease
3.00%	264	294	11.36%
5.00%	28	53	89.29%

3-Year Cap Cost (bps)			
Strike Rate	1/27/2023	1 month ago	% Decrease
3.00%	331	388	17.22%
5.00%	54	93	72.22%

Interest rate cap pricing continued to improve in January as a result of front end rates dropping 20bps this month and volatility settling as traders gain a little more confidence on their outlook. The lower volatility had the largest pricing impact on caps with a higher, out-of-the-money strike rate. For example, a cap with a 5% strike rate and three year term has decreased by 70%+ over the past month. We expect this trend to continue as the economy slows and the Fed nears the end of the current tightening cycle.

Have questions about your next cap or anything else in this update? Contact us at:

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