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The Major bond letter

#47. Right kind of boring

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Fixed Income - Rates

Global

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It was March 2022 when the Fed started to hike rates, having kept them at zero for two full years. Little did we know at the time that it was to be the most aggressive tightening cycle for 40 years. Two years on, investors are looking for something a little less exciting, boring even.

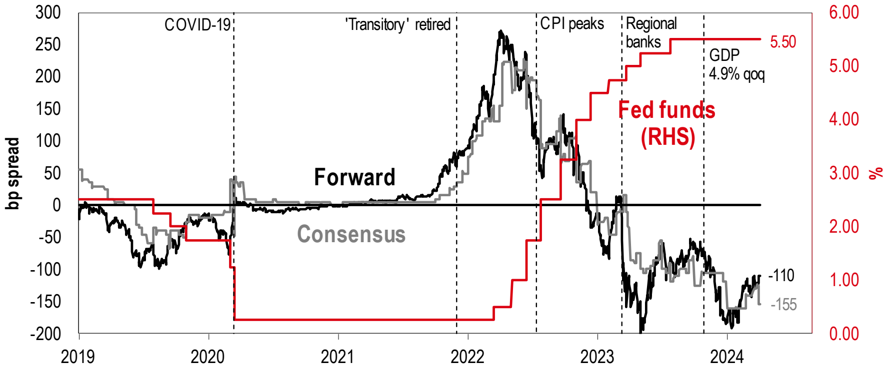
We know that bonds tend to move in advance of policymakers but can be surprised by the extent to which market expectations can under-or over-estimate both the speed and magnitude of change. This is shown by moves in the forwards[1]. Our chart maps the one year forward rate (1Y1M) and Bloomberg consensus forecasts for policy rates one year hence. To capture the speed and scale of change we calculated the spreads versus the prevailing spot rate. For the forward series we deducted the underlying one-month money market rate, and from the consensus we reduced by the policy rate.

The chart also plots the Fed funds rate (red line) through a full five-year cycle. The upper bound of the policy rate was 2.5% at the beginning of 2019, then started to fall in response to the slowing economy, before being taken straight down to the zero bound in March 2020, following the economic shock of the global pandemic. It stayed there for two years before the start of what was to be the most aggressive tightening cycle of the last four decades.

What are the four key takeaways from this chart?

First, the huge scale of the moves. The grey line shows the one year forward spread, which has a current reading of -110bp, the market's estimate of how much easing there will be over the next year. Note that the range depicted by the left-hand y-axis is over 450bp, defined by "peak hawkishness" at 272bp (5 April 2022) and the most dovish expectation of -200bp (4 May 2023). The shift in rate expectations has been anything but boring through the last two years shown on the chart.

The market moves well ahead of the Fed but underestimates the moves



Source: Bloomberg, HSBC. Note: 'Forward' = USD OIS 1Y1M – 1M. 'Consensus' = Bloomberg survey weighted average for the same quarter, one year ahead, minus Fed funds upper bound.

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Second, look at how the forwards moved several months ahead of policy rates but under-estimated the actual moves. The one year forward was already surging before the Fed retired the reference to "transitory" inflation (30 November 2021). At the first hike on 16 March 2022, forwards were implying over 200bp more over the next year but were, in fact, significantly underestimating the additional 475bp that was to come through in the next 12 months. When the Fed's rate hikes had stepped up to 75bp increments (15 June 2022), forwards were racing ahead by another 150bp, but still some 200bp shy of the end point for the Fed.

The peak for US inflation was reported in July 2022, with June's data, and whilst the Fed was only halfway into the tightening, the forwards were already starting to contemplate a move on from peak hawkishness. We see this by observing the spread between the forward and the underlying one-month rate, which had entered a downtrend.

Third, note how the forwards move several months ahead of the Bloomberg consensus forecast (grey series). To estimate consensus forecasts for Fed funds we took the weighted average from the survey, which had a total of c.70 responses for the most recent one. Apart from the two years (2020-2022) when rates were at the zero bound, the consensus nearly always follows the forwards and we think this could be because forecasters are likely responding to the market moves. Forecasts that add no more informational value than the forwards are arguably either boring, showing a lack of view, or both.

Fourth, today's spreads – both consensus and forwards – are towards the lower end of the range, expecting 120-130bp of easing over the next year, pretty much in line with the Fed's guidance in the dot plot. But the forward is the weighted average of all plausible outcomes and should not be confused with a baseline forecast (*Going binary*, 11 December 2023). To regard 120-130bp as too much or too little easing requires a view on both the forward level ***and*** its spread to the underlying.

Our chart shows how the spreads have a directional bias aligned to the policy rate. The Fed funds rate range is currently 5.25-5.50%, and we described above how forwards significantly underestimated the scale of the Fed's rate hikes. Given that the Fed has guided towards lower rates, it is likely that a large proportion of the spread between forwards and the underlying rate will roll to the next meeting when the rate cuts start. This is unless, of course, there was the highly unlikely guidance that the Fed was not going to cut or that it was committed to "one and done".

Investors in bonds are traditionally attracted by the income on offer and diversification benefits versus other asset classes. Bonds are anyway not supposed to be competing directly with equities, which have recently been generating double figure annual returns. They are meant to be, well, boring.

"Fixed income" describes an asset class synonymous with a steady source of income, not rapid price gain or loss. Bonds historically served as a relatively reliable source of income for widows and orphans, and in more modern times, provide the ballast to a portfolio mixed with risky assets.

In the Autumn of 2023, bonds were on track for an unprecedented hat-trick of down years. For the year to 19 October 2023, the Bloomberg US Treasury index[2] was down 3.30%, and this was following declines of 2.7% in 2021 and 11.7% for 2022. As it turned out, thanks to the strong bond rally through the last two months of the year, the index returned a positive 4.05% in 2023.

Given the context of the last three years, and the performance of other asset classes, the performance of bonds has started to appear, on the surface at least, boring, a state of mind that happens when we're in search of a stimulation that just isn't there. It appears double-digit losses are in the past, and low single digit gains have resumed. The right kind of boring.

[1] The forward is the interest applicable in the future. It is calculated using today's spot rates and adjusting for the cost of carry so as to equate the total return on the longer-run investment to rolling-over shorter dated equivalents.
[2] Bloomberg US Treasury Total Return index (LUATTRUU). Total return includes price change, coupon, and reinvestment income. The index excludes Treasury bills and has an average maturity of 7.83.

Previous editions of 'The Major bond letter'

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