Strong Data Muddles Fed Policy Picture

by Komson Silapachai

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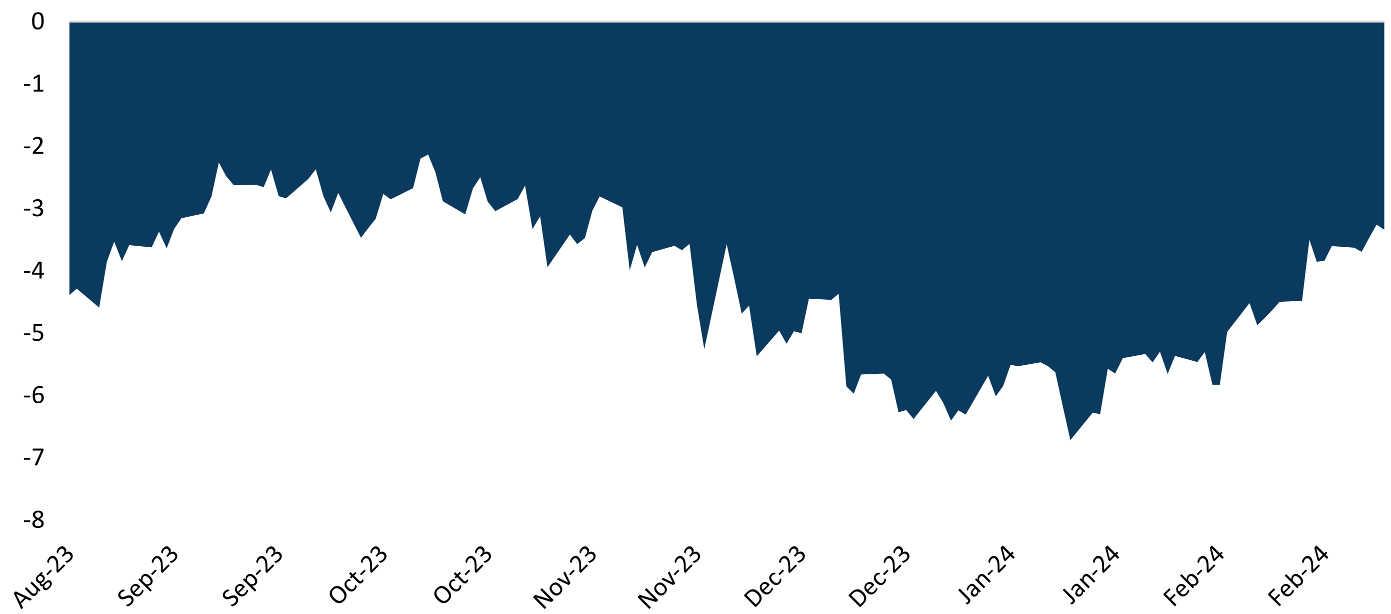
Economic data remains robust with the latest jobless claims falling by 12k jobs last week to 201k, while consensus had called for an increase. The jobs data adds to the slate of strong labor and inflation readings, which have caused a shift in Fed communication this month. The Fed has pushed back on any near-term rate cuts and encouraged a patient, data dependent approach. We continue to expect a mid-year start to the FOMC's interest rate cuts, with three to four cuts total in 2024; however, the scope for a "no-landing" scenario, in which the economy reaccelerates, has widened given the recent strong economic data.

Since the January FOMC meeting, the Fed "pivot" has transformed into a pushback as bond yields sharply reversed their rapid descent that took place at the end of 2023. Led by the short end, yields have risen across the curve, with the 2y Treasury yield selling off by 45 bps to account for the lower probability of near-term cuts. Interest rate markets are now implying three cuts through December 2024, which is less than what was priced in before the Waller speech that signified the most recent FOMC pivot.

Number of FOMC Rate Moves Priced in by Markets

(Negative = No. of cuts, Positive = No. of hikes)

Source: Sage, Bloomberg



Last week's FOMC minutes largely supported the message that Fed Chair Jerome Powell had signaled after the January FOMC meeting, which was that current conditions do not warrant a near-term rate cut. In the minutes, the FOMC "remained highly attentive to inflation risks" and "most" participants saw the risk of the Fed acting "too quickly to ease the stance of monetary policy." The Committee also acknowledged the risk that easing financial conditions could "cause progress on inflation to stall."

Regarding the Fed's balance sheet policy and potential slowing of balance sheet runoff, the minutes stated that the Committee believed "it would be appropriate to begin in-depth discussions of balance sheet issues" at the next FOMC meeting. So, we should receive more details after the March FOMC meeting. We still believe the Fed will start to taper its QT program around mid-year given concerns around financial stability.

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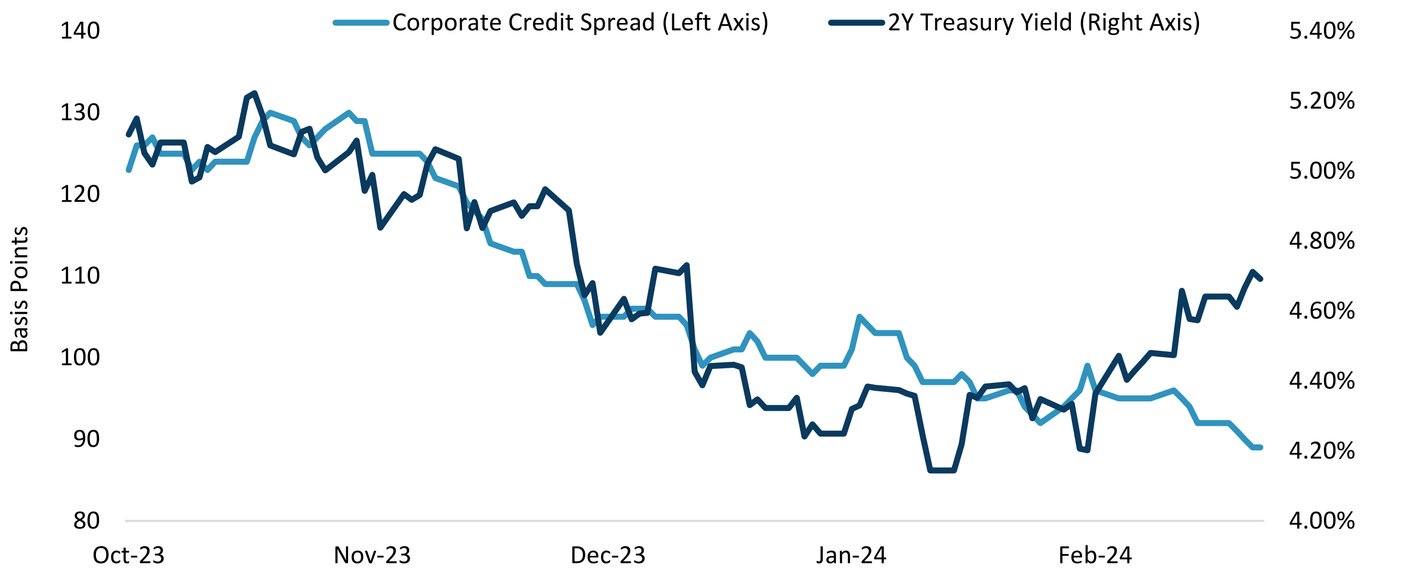
Corporate spreads remain unbothered by interest rate volatility. Whether it's the $6 trillion-plus of money market assets searching for additional yield or some other reason, inflows into high-quality US fixed income remain robust. Corporate credit spreads are now 89 bps above Treasuries, which is the tightest since 2021 and close to the post-Covid low of 80 bps. Despite rising bond yields this year, credit spreads have been remarkably resilient.

IG Corporate Spread versus 2Y Treasuries

Source: Sage, Bloomberg



A report by Bank of America Merrill Lynch research estimated that investment grade bonds are on pace to see $500 billion in inflows this year, which will be the highest of all-time by a wide margin. We still believe valuations for corporate bonds remain full, especially for a long-term investor, so we are being selective about where we take spread exposure. But we can't deny that the insatiable demand for high-quality fixed income in a strong US economic environment should continue to support spread sectors.