

Fed's Hands Tied in a Gordian Knot

Despite the Fed's initial pivot towards easing policy, challenges in achieving the 2% inflation target have led to uncertainty regarding the timing and extent of potential rate cuts, prompting investors to debate the outlook for monetary policy.

Fresh off a December pivot in Fed rhetoric, in which policymakers indicated that the cycle of tighter policy was over and easier policy would commence shortly, the resilient US economy and sticky inflation have delayed these best laid plans. In fact, following several first quarter economic releases, including March's robust gain of 303,000 new jobs, core CPI remaining elevated at 3.8%, and the Employment Cost Index surprise beat of 1.2%, Powell and team found their hands entwined in a Gordian knot.

The ancient Greek legend, a prophecy in which anyone able to untie the complex knot would be destined to rule all of Asia, posed quite a challenge. After struggling to untie the elaborate knot, it is said that Alexander the Great pulled out his sword and sliced the knot in half. Having later conquered Asia, Alexander the Great fulfilled the prophecy.

The Fed's earlier pivot to an easing bias grew problematic as confirmation that inflation is moving toward the desired 2% target

remained elusive. Investors, having enthusiastically seized upon the prospects for rate cuts, moved the markets aggressively at the end of last year. However, firm economic growth and elevated price levels made it difficult to justify 6 or 7 rate cuts. Since then, expectations for rate cuts have plummeted to one or two moves later in the year. With each economic indicator, market participants continue to debate the timing and amount of potential Fed rate cuts, while Fed Chair Powell and other central bankers reiterate that policy remains restrictive and they need to be patient and await confirmation of softer inflation.

With the Fed's hands tied, and "higher for longer" the prevailing sentiment, fixed income investors are able to enjoy higher yields and lower risks. For quite some time, the allure of short-term yields north of 5% has been compelling, leading to the successful "T-bill and chill" strategy. However, with real rates (nominal yields less inflation) at very attractive levels, coupled with the risk that higher for longer policy increases the probability of recession,

Interest Rate Scenario Analysis

This analysis illustrates the total return of the US Treasury security of a set maturity, over a given time period and a range of interest rate shifts

Treasury Benchmark On-the-Run Issues	Estimated 12-month Total Return for Benchmark U.S. Treasury Notes and Bonds, Assuming a Parallel Shift in Interest Rates												
	+300bps	+250bps	+200bps	+150bps	+100bps	+50bps	0bps	-50bps	-100bps	-150bps	-200bps	-250bps	-300bps
2-Year US Treasury T 4 7/8 04/30/26	2.00%	2.44%	2.89%	3.34%	3.79%	4.25%	4.71%	5.18%	5.64%	6.11%	6.59%	7.06%	7.54%
3-Year US Treasury T 4 1/2 05/15/27	-0.97%	-0.09%	0.81%	1.72%	2.64%	3.57%	4.51%	5.46%	6.42%	7.40%	8.38%	9.38%	10.40%
5-Year US Treasury T 4 5/8 04/30/29	-5.73%	-4.14%	-2.52%	-0.86%	0.84%	2.57%	4.33%	6.14%	7.98%	9.87%	11.79%	13.76%	15.77%
7-Year US Treasury T 4 5/8 04/30/31	-9.81%	-7.62%	-5.38%	-3.06%	-0.67%	1.79%	4.33%	6.94%	9.64%	12.42%	15.28%	18.23%	21.28%
10-Year US Treasury T 4 3/8 05/15/34	-15.14%	-12.23%	-9.19%	-6.03%	-2.72%	0.74%	4.34%	8.11%	12.05%	16.17%	20.47%	24.96%	29.66%
20-Year US Treasury T 4 1/2 02/15/44	-24.98%	-20.98%	-16.65%	-11.97%	-6.90%	-1.41%	4.54%	11.00%	18.01%	25.62%	33.89%	42.89%	52.69%
30-Year US Treasury T 4 5/8 05/15/54	-30.56%	-26.17%	-21.29%	-15.86%	-9.81%	-3.06%	4.50%	12.98%	22.49%	33.20%	45.25%	58.86%	74.24%

Data Source: Bloomberg as of May 15, 2024

investors should increase exposure to longer-term maturities. For example, with the 10-year Treasury yield at approximately 4.35%, and inflation potentially averaging 2.0-2.5% for the next ten years, investors can potentially obtain an historically attractive real return of around 2%. Current yields also create compelling risk-return dynamics over a 12-month horizon.

Following some recent economic releases pointing to moderating prices and economic growth, including today's lower April CPI print and the weaker than expected April jobs report, rate cut optimists have sparked a bond market rally as many investors once again adjust estimates for additional interest rate reductions. However, while the Gordian knot may have loosened modestly over the past few weeks, most Fed policymakers have been quick to preach patience as one or two softer inflation figures remain insufficient evidence that price gains are moving down to the Fed's target. Thus, while the Fed grapples with the challenge of untying its hands and determining appropriate policy, we are capitalizing on the attractive risk-return opportunities by adding duration to our portfolios and locking in these long-term rates.

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Maturity - In finance, maturity or maturity date is the date on which the final payment is due on a loan or other financial instrument, such as a bond or term deposit, at which point the principal (and all remaining interest) is due to be paid. **Interest Rates** (aka Federal Funds Rate) - The federal funds rate refers to the interest rate that banks charge other institutions for lending excess cash to them from their reserve balances on an overnight basis.

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