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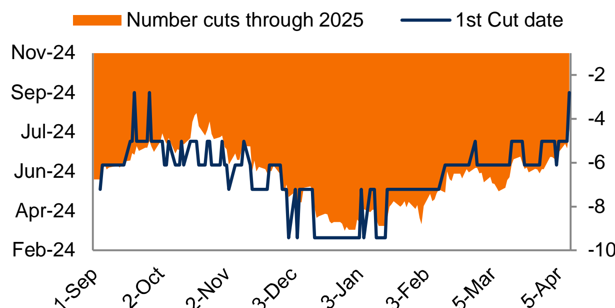
10 April 2024

Q2'24 update: Higher for longer

What began as a year filled with rate cut hopes has slowly evaporated as the extraordinary performance of the U.S. economy has not yet provided the Fed with convincing signals that inflation will convincingly reach 2%. For the moment, the Fed continues to expect 3 cuts this year, the first of which the market still anticipates as a summertime treat. There is growing consternation over this view however, among both FOMC members and investors. The binary outcome of 3 cuts versus none is also testing the extension strategy that most money funds pivoted towards last fall. We are starting to see varying approaches to duration as WAMs are again falling in the face of an inverted money market curve and rate cut uncertainties. We suspect that bifurcated duration strategies will continue to emerge as the widening opinions over the Fed's willingness and ability to start rate cuts in the next quarter intensify.

What a difference a quarter makes! In our last update, we questioned the veracity of the market's aggressive pricing for rate cuts to begin in Q1:24, setting off a path of additional cuts with a more-than-quarterly cadence. True to form, strong employment and inflation data since then has pushed off the eventual start to the normalization process, and also called into question the pace of any cuts to follow. As shown in Figure 1, Fed rate cuts are now expected to start this fall, while overall normalization through the end of 2025 have been reduced to under 5 cuts, a significant adjustment from the 9 cuts that were expected near the start of the quarter.

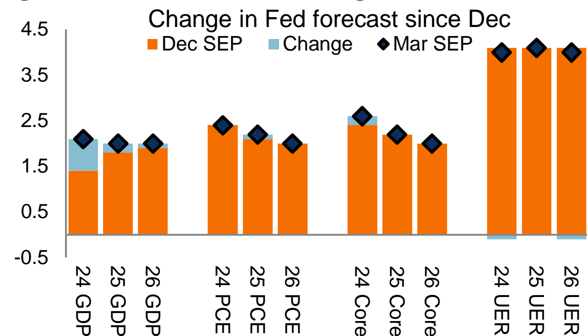
Figure 1 Later and less



Source: State Street Global Markets, Bloomberg

Following the Fed: For what it's worth, the Fed has been steadfast in its view that the path to 2% inflation would be a bumpy one. It first pushed back against March cuts at its January meeting, and again acknowledged that data remained hotter than expected at the March FOMC meeting. Figure 2 summarizes how the committee's projections have changed over the past quarter. It is notable that growth has continued to surprise to the upside, prompting GDP mark-ups in each of the next three years, with above-trend growth now expected through 2026. As impressive as this appears, growth gains are expected to only minimally impact inflation and employment, thereby achieving the Fed's dual mandate of fuller employment and price stability. It is within this context that the Fed maintained its rate outlook of 3 cuts for 2024, although it trimmed rate cuts for 2025/26 while also minimally raising its long-term funds outlook. In total, our read of these changes is that Fed forecasts are signalling an even softer landing, although we are getting precariously close to no landing at all.

Figure 2 An even softer landing

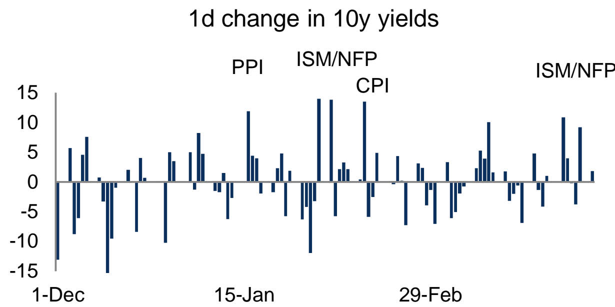


Source: State Street Global Markets, Federal Reserve, Bloomberg

Data dictates: We think that the Fed started the year fully expecting that the positive data trends that emerged in 4Q:23 would continue and thereby allow them to easily start the normalization process soon. Recall that Chair Powell told Congress at the start of March that the FOMC was getting close to gaining the confidence that would allow them to start normalizing rates. And while he was willing to dismiss hot data in Jan & Feb when he made this statement, a continuation of strong job gains and stickier inflation is sowing the seeds of doubts amongst both the FOMC and markets. Investors have therefore gone into hyper-data-dependency mode, with 10-bps moves in overall yields becoming somewhat common around data releases (Figure 3). This has led to a 60% retracement in 2y yields from October's high to the mid-January low, as it presently settled at just shy of 4.8%, while 10y yields are closing at their YTD highs.

Information Classification General
Complimentary Material

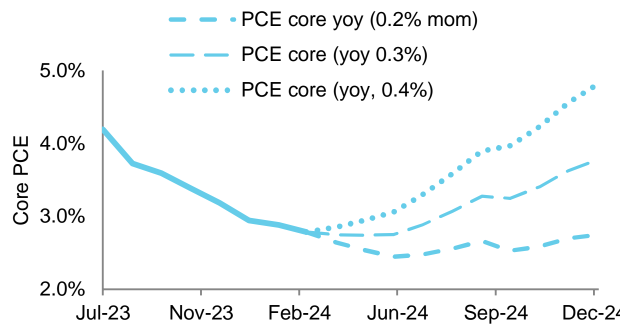
Figure 3 Data dependent



Source: State Street Global Markets, Bloomberg

No relief yet: As of this writing, the strong March jobs report is being described as flawless, with +303k jobs the strongest in almost a year. It also raises the 3mo average to 270k, well above the 100k that the Fed had previously signalled an employment goal. And while muted wage gains likely provide the Fed cover to remain ambivalent over the strength in jobs, it has much less wiggle room on the inflation front. On that front, March CPI was once again hot, and a continuation of monthly core gains of 0.3%/0.4% makes reaching even the Fed's modified PCE goals challenging. Figure 4 shows that the Fed's 2.6% year-end target is at risk unless inflation starts to regularly post 0.2% increases, something that has yet to occur this year.

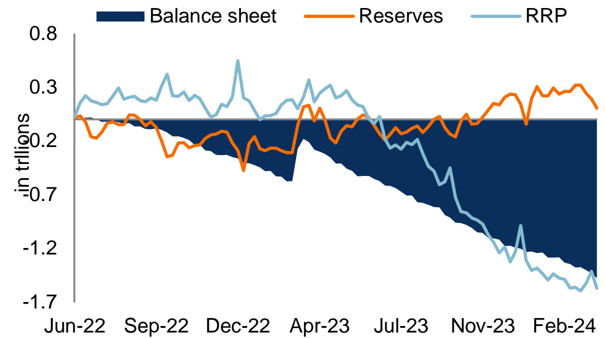
Figure 4 Base effects to make inflation gains harder



Source: State Street Global Markets, Bloomberg

To QT or not to QT: Powell's QT update carried a similar bravado to his rates outlook, as he maintained that the Fed would begin to taper the QT process "fairly soon." We nonetheless continue to hear conflicting Fed voices on the topic; with the likes of Lorie Logan sounding more dovish as she advocates for an earlier start to the tapering process, while others (including Waller and Williams) hawkishly hint that QT may continue for an extended period, even if there is a moderate taper soon. Neither outcome is mutually exclusive, although we do feel the varying approaches are spiritually at odds with each other. For our part, we don't understand why the Fed would even consider changing the QT process as bank reserves are largely unchanged since June, 2022 (Figure 5). We do think there are economic ramifications for maintaining an overly large balance sheet that supports the view that higher term premiums could drive bear steepening if QT ends prematurely.

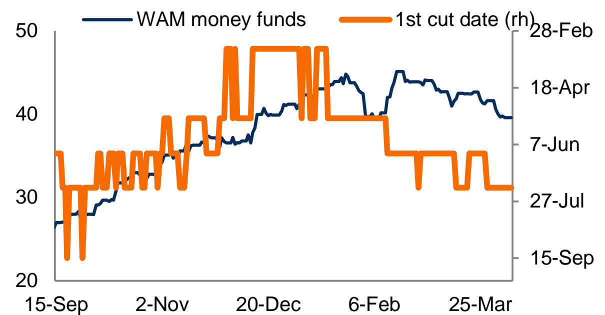
Figure 5 Still abundant



Source: State Street Global Markets, Bloomberg

Extension risk: One of the more widely adopted strategies for money market managers was to extend the WAM of their portfolios as imminent rate cuts provided the incentive to lock in yields after extensively using the Fed's RRP facility last year (Figure 6). As the benefit of this strategy is not as patently clear at the moment given the higher for longer world we find ourselves, WAMs have begun to fall again.

Figure 6 Extend and forget?



Source: State Street Global Markets, Bloomberg

Our proprietary data shows a similar pattern (Figure 7), with underwhelming flows into 1m T-bills relative to history. The continued inversion of the bills curve means that this approach will reduce returns the longer rate cuts are delayed. We suspect that WAM strategies for MMF managers will start to diverge as opinions about the Fed's timing and ability to cut rates start to more drastically diverge from the summer cut base case.

Figure 7 Short bill flows set to rebound

Source: State Street Global Markets, Bloomberg

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