Insights
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clearwater ADVISORS

## Tightening Taken with a Big Grain of Salt

The dot plot for the June FOMC meeting was unexpectedly hawkish as Fed officials, at the median, forecasted two rate hikes by the end of 2023. This was in contrast to the prior March reading that anticipated zero rate hikes. Uncertainty and risks around inflation appear to be the primary drivers to the hawkish impulse as forecasts for real GDP growth and unemployment were mostly unchanged.

| | Real GDP | Unemployment | PCE | Core PCE |
|---|---|---|---|---|
| **Diffusion Index on Uncertainty Assessments** | | | | |
| March 2021 | 0.83 | 0.89 | 0.89 | 0.89 |
| June 2021 | 0.83 | 0.89 | 1.00 | 1.00 |
| **Diffusion Index on Risk Weightings** | | | | |
| March 2021 | 0.06 | -0.06 | 0.22 | 0.22 |
| June 2021 | 0.06 | -0.06 | 0.72 | 0.72 |

Source: Federal Reserve. Each point in the diffusion indexes represents the number of participants who responded "Higher" minus the number who responded "Lower," divided by the total number of participants.

Hotter than expected inflation prints since the last FOMC meeting may have left some uneasy, but when assessing the dots the question is to what extent Fed officials are carrying forward lagging inflation data. Price action on the categories of goods and services contributing the most to the run-up in inflation (e.g., used cars, airfare, hotels) should prove to be temporary. Coupled with a slowdown in May retail sales, economic data released since March give credence to the transitory inflation narrative. If labor force participation improves and relieves the supply side pressures that are leading to strong wage increases, inflation uncertainty could start to abate. However, if slowed vaccine adoption and/or the emergence of more highly infectious variants keep labor supply tight, then anticipated rate hikes forecasted by the dot plot may come to fruition.

Currently, fed fund futures anticipate the first hike to occur by March 2023 and the second hike to occur by October 2023. A third hike is not priced into futures until December 2024. When referring to the dot plot Chairman Powell said it should be taken with a "big grain of salt." The same can be said of fed fund futures pricing. Neither have historically predicted the pace of monetary policy tightening with any accuracy. The Fed still needs to navigate asset purchase tapering without roiling markets too much, and a hiking cycle combined with active tapering may be too much for markets to bear. This would be concerning for a Fed that has been hyper-focused on maintaining stable financial conditions. In our view, the Fed will ultimately remain cautious in raising rates. Whether this leads to a policy mistake is, for better or worse, a longer term concern that will extend well beyond 2023.

In terms of rates positioning for today, we think a 2s5s barbell makes sense for corporate treasury investors looking to put excess cash to work. The two-year has finally perked up reaching one-year highs. Proceeds from these maturities can be rolled into higher rates as monetary policy normalizes. If fed fund futures are correct in timing, carry on the five-year should provide adequate compensation. On the other hand, should fed fund futures prove too optimistic, the five-year will likely outperform should the Fed reinforce a dovish stance especially if inflation fails to maintain above two percent.

On the longer end of the curve, a backup in rates could gain momentum through the rest of the year especially if lawmakers can come together on a bipartisan infrastructure package. For now, upside surprises to economic growth, as reflected by the Citi Surprise Index, have been restrained leaving little catalyst for higher yields as reopening enthusiasm should already be priced in.



Clearwater Advisors · 101 South Capitol Boulevard · Suite 1201 · Boise, ID 83702

www.ClearwaterAdvisors.com