# Insights

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## Unprecedented Front-End Repricing Creates Opportunities

The Fed has clearly pivoted hawkish coming into 2022. Fed fund futures are now pricing in nearly five rate hikes compared to just one hike priced in at the end of 3Q21.

Markets were seemingly unprepared for the Fed's hawkish tone in the last quarter of 2021. Understandably so as various Fed officials, with Chair Powell at the forefront, towing the transitory inflation narrative. This posturing gave credence to the idea that dot plot forecasts were again too optimistic as they had consistently been during the last rate hiking cycle. However, minutes from the December FOMC meeting as well as Powell's most recent FOMC press conference highlighted a sense of urgency to address persistently high inflation.

The front-end of the yield curve repriced dramatically given the relatively abrupt reassessment of Fed thinking. Total return in the ICE BofA U.S. 1-Year Treasury Bill Index was negative during the last quarter of 2021. Even though the index eked out a return of +0.03% for 2021, it was the lowest annual result in the post-GFC era by nearly 0.18 percentage points. Returns in January 2022 were unprecedented; the index returned -0.29% compared to the next lowest post-GFC era monthly return of -0.12% which occurred in February 2009.

The lack of detailed guidance on rate hikes creates uncertainties for investors, but risk of continued underperformance in the longer duration part of the front-end is much more balanced today due to the steeper yield curve. Based on our scenario analysis, the Fed would need to hike 25 bps at every meeting in 2022 (seven times) in order for the 1-year T-Bill to underperform a government money market fund (MMF). A laddered Treasury portfolio with the same expected return as the 1-year T-Bill should protect against the risk of upside rate hike surprise in addition to meeting liquidity needs.

| Clearwater Advisors Scenario Analysis | T-Bill | Government MMF* | | | |
|---|---|---|---|---|---|
| **Projected Returns (2/1/22 - 12/31/22)** | **1-Year** | **4 Hikes** | **5 Hikes** | **6 Hikes** | **7 Hikes** |
| Projected Annualized Yield | 0.775% | 0.558% | 0.570% | 0.751% | 0.826% |
| Projected Income per $100 Million | $709,178 | $510,329 | $521,973 | $687,041 | $756,219 |
| **Relative Returns vs. T-Bill Portfolio** | **1.00x** | **0.72x** | **0.74x** | **0.97x** | **1.07x** |

* Starting 7-day yield of 0.03% (based on current MMF yields), 25 bps for each rate hike, hikes are immediately reflected in higher yields
†This is a hypothetical example for illustrative purposes only and is not intended to reflect the actual performance of any security. Investing in securities involves risk and may result in a profit or loss.

Our analysis assumes that MMF yields will be able to immediately capture higher interest rates after each rate hike announcement, which was not the case during the last cycle that commenced in 2015. A sampling of government MMFs shows that it took most funds two to four hikes before their yields fully caught up to higher fed funds. This was due to MMFs reinstating fees that had been waived because of low rates. As a side note, bank deposits were even slower to reprice rate hikes.

The probability that the Fed hikes seven times, reaching an upper bound rate of 2% by the end of 2022, appears low as the Fed is likely to pursue balance sheet reduction later this year. Monetary policy aggressiveness should also account for the eventual recovery of supply chains and the absence of fiscal stimulus that resulted in elevated consumption and labor demand. Heightened geopolitical and global macroeconomic risks that delayed the pace of hiking during the last cycle could also affect the Fed's thinking this time as well.