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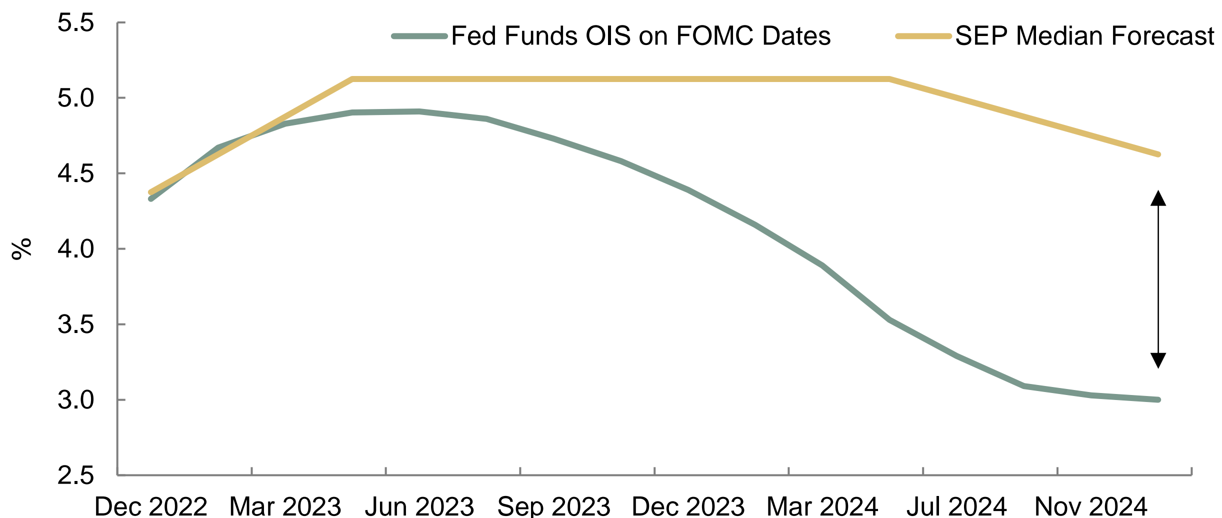
Bond Market to the Fed: We Don't Believe You

The bond market is always right. That is what the yield curve has taught us. **Every time the slope is negative, a recession ensues**. This time is not different. Our preferred metric is the 2s10s curve, which is around -80 basis points (bps). This is the biggest inversion since 1981 but is much larger in relative terms if we normalize for today's lower yields. For us, the only questions are, when does the recession start, and how deep is it?

Yesterday's FOMC statement, press conference and economic forecasts were all hawkish. **The Fed raised its estimate of the terminal funds by 50 bps to 5.125%**, which policymakers expect to hit next year. In our view, this implies three successive 25 bp rate increases beginning next February. The Fed told us to expect the funds rate to remain at 5.125% through the remainder of 2023, with the first cuts(s) coming in 2024 and totaling only 50 bps. The bond market does not believe these forecasts and neither do we.

On Monday the futures market was pricing a 4.73% December 2023 fed funds rate. This implies a 25 bp rate cut in next year's peak funds rate of 4.875%. Despite the new FOMC forecasts, fed funds futures are still expecting a 4.875% terminal rate. More importantly, **the bond market is now predicting a large 75 bps in rate cuts by the end of next year**. In the chart below, we show the implied FOMC rate forecasts versus market expectations. What a difference between the Fed and the market! But **if our real GDP growth and inflation projections are accurate, 2023 official rates are likely headed lower sooner and by an even larger amount than the market thinks**.

As our past work has demonstrated, **the shift from monetary tightening to easing is fast**. Over the past 18 hiking cycles, the average time from the last rate increase to the first rate decrease is three months. In addition, when recession risks are elevated, the Fed tends to move aggressively, certainly more than what is currently built into the futures market. Nevertheless, the broad contours of the bond market's rate trajectory are correct.



Source: Bloomberg, FRB, Haver, SMBC

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