GUGGENHEIM

March 22, 2021

Macro Alert
The Fed's Mixed Messaging on the Yield Curve

From the Office of the
Global Chief Investment Officer,
Scott Minerd

By the Macroeconomic and
Investment Research Group

Brian Smedley
Senior Managing Director and
Head of Macroeconomic
and Investment Research

Matt Bush, CFA, CBE
Director and Senior Economist,
Macroeconomic and
Investment Research

Last week Fed Chair Jay Powell emphasized that the Fed intends to maintain rates at zero even when the economy overshoots traditional measures of full employment and price stability, but he stopped short of pushing back explicitly on the recent bear steepening of the Treasury yield curve.

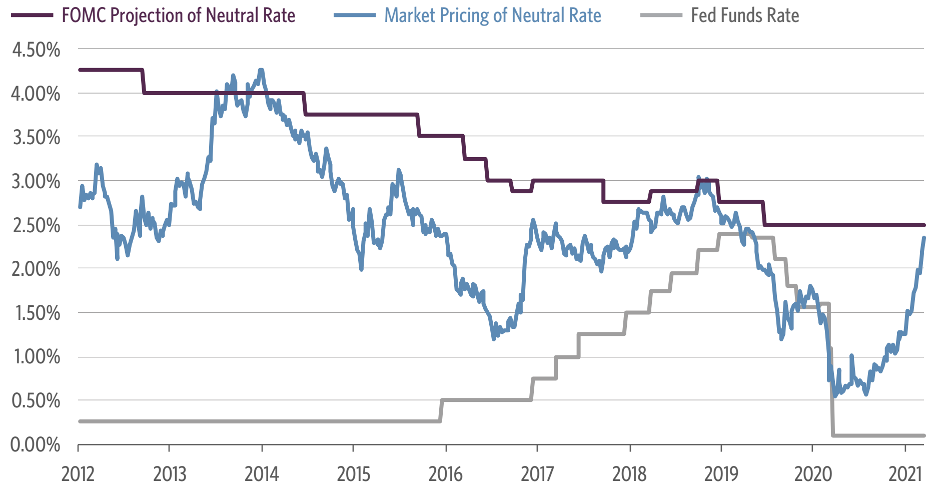
As we see it, Powell is giving conflicting guidance to the market (like any good two-handed economist). On one hand, short term rates will stay low for a very long time, which is bullish for the short end of the yield curve. On the other hand, the Fed will do what it takes to support the recovery and lift inflation expectations to what it deems to be more appropriate levels, which has been bearish for the long end of the yield curve. The intermediate sector of the curve is caught in the middle.

The question investors face is whether the selloff has more room to run. Our analysis suggests it has largely run its course.

One approach we take in determining the fair value of long-term Treasurys is to compare the market's pricing of the "neutral rate"—the federal funds rate that is neither stimulative nor restrictive—to the FOMC's projections of the neutral rate (and our own, of course). As the chart below shows, the market has dramatically repriced its estimate of the longer-run equilibrium fed funds rate over the past eight months. Meanwhile, the Fed's projection of neutral has remained at 2.50 percent since mid-2019.

Today the market is pricing in a longer run rate of 2.35 percent, well above the current fed funds rate and nearly in line with the Fed's optimistic neutral rate projection. As the chart shows, the bond market has had difficulty sustaining rates at or near the Fed's neutral rate projection, and we see no reason to expect a different result this time. Nor do we expect the Fed to revise up its neutral rate estimate, given ongoing structural headwinds that the pandemic has only accelerated (including increased inequality, more precautionary saving, and higher debt burdens, to name a few).

The Fed's Optimistic Neutral Rate Projection Is Almost Fully Priced In

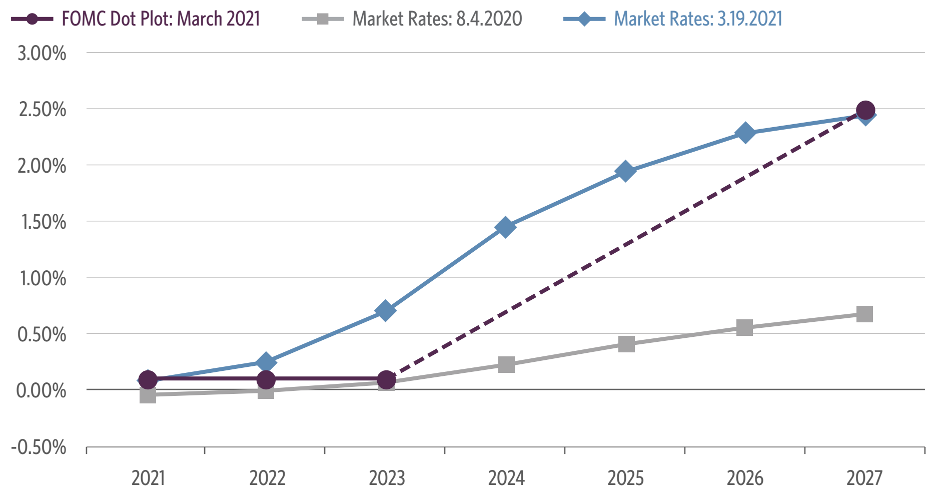


Source: Guggenheim Investments, Bloomberg. Data as of 03.19.2021. FOMC neutral rate projection is the median "Longer Run" dot from the Summary of Economic Projections. Market neutral rate projection is the 5-year forward 5-year Overnight Index Swap rate. Fed Funds Rate is depicted using the interest rate on excess reserves.

While the Fed has succeeded in lifting growth and inflation expectations (with help from the Biden administration), it now has a different problem: the market is pricing in an overly aggressive path of rate hikes in the next several years, as the chart below shows. The upshot for bond investors is that the steeper yield curve now offers a much more attractive carry and rolldown profile than it did just a few months ago. If the Fed is as patient in coming years as we expect it to be, total returns for core fixed income investors will be much better going forward than they have been in the recent past.

The Bond-Market Now Believes the FOMC's Long-Term Rate Forecast, But Not its Short-Term Forecast

Forward Rates at Year-End



Source: Guggenheim Investments, Bloomberg, Federal Reserve Board. Data as of 03.19.2021. Note: FOMC rate projections are available for 2021-2023. The FOMC defines its "Longer Run" forecast as being 5-6 years into the future.

IMPORTANT NOTICES AND DISCLOSURES

Investing involves risk, including the possible loss of principal.

This material is distributed or presented for informational or educational purposes only and should not be considered a recommendation of any particular security, strategy or investment product, or as investing advice of any kind. This material is not provided in a fiduciary capacity, may not be relied upon for or in connection with the making of investment decisions, and does not constitute a solicitation of an offer to buy or sell securities. The content contained herein is not intended to be and should not be construed as legal or tax advice and/or a legal opinion. Always consult a financial, tax and/or legal professional regarding your specific situation.

This material contains opinions of the author or speaker, but not necessarily those of Guggenheim Partners or its subsidiaries. The opinions contained herein are subject to change without notice. Forward looking statements, estimates, and certain information contained herein are based upon proprietary and non-proprietary research and other sources. Information contained herein has been obtained from sources believed to be reliable, but are not assured as to accuracy. No part of this material may be reproduced or referred to in any form, without express written permission of Guggenheim Partners, LLC. There is neither representation nor warranty as to the current accuracy of, nor liability for, decisions based on such information. Past performance is not indicative of future results.

Guggenheim Investments represents the following affiliated investment management businesses: Guggenheim Partners Investment Management, LLC, Security Investors, LLC, Guggenheim Funds Distributors, LLC, Guggenheim Funds Investment Advisors, LLC, Guggenheim Corporate Funding, LLC, Guggenheim Partners Europe Limited, Guggenheim Partners Fund Management (Europe) Limited, Guggenheim Partners Japan Limited, GS GAMMA Advisors, LLC, and Guggenheim Partners India Management.

© 2021 Guggenheim Partners, LLC. All rights reserved.