GUGGENHEIM

Rates

Positioning for a Policy Transition

We expect the Treasury curve will steepen when the Fed pauses.

2023 has been remarkable in terms of interest rate volatility and continual changes in market sentiment. In January, market participants had concluded that a Fed pivot was close at hand, and Treasury yields and terminal rate pricing moved lower across the curve. Then in February, employment and inflation data came in stronger than expected, and Treasury yields and terminal rate pricing moved sharply higher again. This trend continued into the first part of March, with terminal rate expectations reaching as high as 5.6 percent before the regional banking crisis led to a substantial drop in the expected path for fed funds. April saw a return to more normal markets but yields still well off the highs.

The Fed continued on its path of fighting inflation with another 25 basis point hike in May, thereby increasing front-end rates further and modestly flattening the curve. The decision came with a notable change in tone that the markets interpret to mean an increased chance of a pause from here, which could keep the curve flat for an extended period. However, we believe that the yield curve will bull steepen—i.e. short-term rates fall faster than long-term rates, increasing the spread between the two—as the eventual easing cycle comes into play next year.

Boosted by heightened interest rate volatility and the Treasury market flight to quality created by banking sector turmoil, Treasury yields declined by 30–40 basis points across the curve, and produced market returns of 3.0 percent during the first quarter. Longer maturity Treasurys fared even better, returning 6.5 percent over the same period. Looking forward, we expect Treasury returns will be positive and primarily driven by coupon income as rates remain relatively rangebound for the next few months with the Fed on hold. A pause by the Fed would be positive for sentiment as a pause is typically followed by an eventual easing cycle, which leads to lower yields and steeper curves.

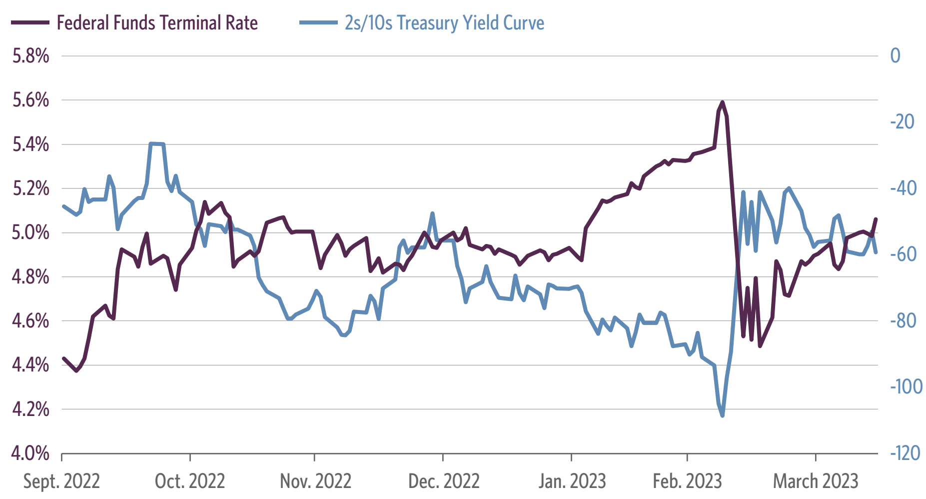
We continue to take advantage of any moves higher in Treasury yields at the short end and intermediate parts of the yield curve, reducing existing underweight positions there and smoothing duration exposure across the yield curve. Additional moves higher in volatility and interest rates may also present opportunities to buy callable Agency bonds at attractive levels, although ongoing uncertainty around the debt ceiling will likely lead to elevated volatility and continued kinks in the yield curve. Significant bill issuance would likely follow any resolution.

By Kris Dorr and Tad Nygren

Terminal rate expectations reached as high as 5.6 percent in March before the regional banking crisis led to a substantial drop in the expected path for fed funds.

Large Swings in the Market-Implied Terminal Fed Funds Rate in the First Quarter

Market-Implied Fed Funds Terminal Rate vs 2/10 Treasury Yield Curve



Source: Guggenheim Investments, Bloomberg. Data as of 4.14.2023.

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