Does A Fed Pause Mean Anything?

In late 2020, Federal Reserve Chairman Jay Powell ushered in a term to describe inflation in the US that he will unlikely ever escape: ***Transitory***.

In the Spring of 2021, the Federal Reserve said rates would stay near 0% until at least 2024.

After hiking for 10 consecutive meetings to the tune of 5% in total, the Fed clearly changed its mind! Many would argue that they have gone too far…only time will tell.

Should we trust anything the Fed says? Do their words or precedent of their actions still matter? Have they lost all credibility?

As an investor, one cannot ignore the words or actions of the Federal Reserve. Furthermore, despite their seeming ineptitude at times, they are still among the most important policymakers in the world. Their track record of precision and timing is rather poor. Their directional moves, however, do have meaningful investment implications.

As we near the midpoint of 2023, the consensus view is that the Fed is now going to pause their rate hikes to assess the impact of their actions. They are expected to continue with their efforts to reduce their balance sheet at ~$95 Billion per month.

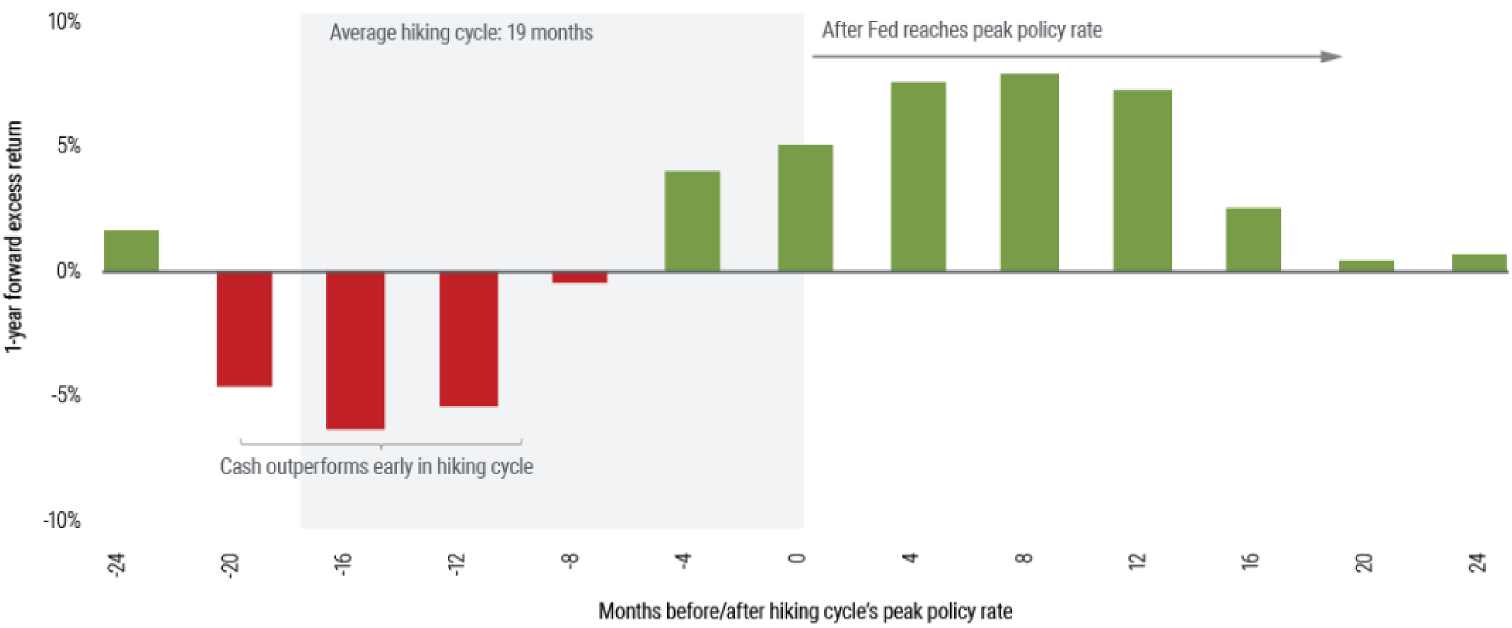
If the Fed pauses, history suggests that extending duration and getting excess cash off the sidelines into other fixed income instruments is likely to be rewarded. The slide that fixed income investors felt in 2022 could quickly be reversed by a Fed pause and eventual Fed cuts.

The timing of potential cuts is hotly debated and not the point of this piece. It is a dynamic we are closely watching. Nonetheless, many investors now face a material risk they haven't seen in over a decade: **reinvestment risk**.

Rather than waiting for the perfect point in time to extend duration, history has shown that the Fed pause is a good indicator that there's a greater probability of rate cuts and lower yields ahead. ***We have started to lengthen duration, continue actively managing credit, and are looking to further reduce our sensitivity to reinvestment risk as we enter the second half of 2023.*** We know our timing will not be exact, but believe bondholders are well compensated for duration today and find themselves with favorable risk/reward in many areas of fixed income over the next 18-24 months.

Figure 1: Core bonds start to outperform cash before the Fed's rate-hiking cycle ends

Fixed income performance across hiking cycles
12-month forward return: Morningstar Core-Plus Category versus T-bills



		12-month forward total return		12-month forward yield change
Average hiking cycle		T-bills	Morningstar Core-Plus	10-year yield change
Months before peak	12 months	5.3%	0.0%	1.1%
	4 months	5.9%	9.8%	-0.8%
Peak	0 months	6.5%	11.4%	-0.8%
Months after peak	4 months	7.3%	14.7%	-1.3%
	12 months	7.2%	14.2%	-1.3%

Source: PIMCO, Bloomberg, Morningstar, Federal Reserve, and Global Financial Data as of 31 March 2023. **Past performance is not a guarantee or a reliable indicator of future results.** All returns and yield data are based on monthly data. T-bill: Citi 3-month T-bill Index.

Hiking cycles are defined as periods where the Federal Reserve embarks on a sustained path of increasing the target fed funds rate and/or target range. We define the end of a hiking cycle as the month where the Fed reaches its peak policy rate for that cycle (i.e., it either pauses rate hikes or cuts). Hiking cycles include (start to peak), 1980 (Jul '80 to May '81), 1983 (Feb '83 to Aug '84), May 1988 (Feb '88 to Mar '89), 1994 (Jan '94 to Feb '95), 1999 (May '99 to May '00), 2004 (May '04 to Jun '06) and 2015 (Nov '15 to Dec '18).

It would be our honor if you would share a copy of this with someone you care about.