October 10, 2023

No Fed Hike In November

Rising Yields Doing The Fed’s Work

After last Friday’s upside surprise in September nonfarm payrolls, one might expect our view that the Fed was done hiking this year to soften. The 336k new jobs exceeded expectations for +170k and was the largest increase in employment recorded since January this year. Moreover, the previous two months’ payrolls were revised upward by 119k. Nevertheless, we reaffirm our call that there will be no rate increase on Nov. 1. We don’t expect a hike on Dec. 13, either, the second day of the last FOMC meeting this year.

We admit, however, that it’s a close call, probably closer than the cumulative 27% odds assigned by the market for one hike over the next two meetings. The chart below shows the market-implied probability of a hike at each of the remaining two meetings this year. Note how these probabilities have evolved over the year. The first few months of 2023 suggested around a 50-50 chance of rate cuts in the fourth quarter, with those probabilities for cuts increasing during the months just after the banking sector stresses of Q2. In retrospect, this dovish market outlook seems quaint and quite outdated at the moment. However, we never really concurred with this view, even then. Now, we are more in line with the market on rate hikes, assigning a low probability to such moves. We did question our view in the immediate aftermath of the jobs report, but three things convinced us to retain our outlook.

First is progress in the inflation battle. The August PCE inflation rate, released about ten days ago, was promising. The three main components of the core (i.e., ex food and energy) all show signs of cooling. Our analysis of the PCE data can be found here. In addition, even in the context of the strong NFP report, we observe a slight cooling in wage growth. While inflation is not yet clearly in retreat, we can’t help but acknowledge these constructive data points. To this end, September CPI released later this week will be crucial.
Second is the almost inexorable rise in bond yields. We have commented on the drivers of this move in two separate Short Thoughts pieces over the past fortnight. We pointed out that both the term premium as well as the implied policy rate ten years hence (from well-accepted models produced by the New York Fed) had risen significantly. Furthermore, we dissected the demand for Treasuries as inferred from our iFlow data and concluded that supply and demand conditions were pointing to lower bond prices (higher yields). This will have tightened financial conditions and should help slow the economy.

Third, we take heed from two speeches delivered this past Monday by Lorie Logan (President of the Dallas Fed) and Phillip Jefferson (Vice Chair of the Board of Governors), which suggested that rates may not have to go higher thanks to the higher term premia we mentioned above. Logan, one of the more hawkish voting members of the FOMC this year, was particularly direct, saying: “Higher term premiums result in higher term interest rates for the same setting of the fed funds rate, all else equal. Thus, if term premiums rise, they could do some of the work of cooling the economy for us, leaving less need for additional monetary policy tightening to achieve the FOMC’s objectives.” On Tuesday, another FOMC hawk, Christopher Waller from the Board of Governors, will speak. If he is similarly equivocal, we feel our case for no more moves becomes even stronger.

**Market Not Expecting A Hike**

![Market-implied probability of FFR increases](image)

*Source: BNY Mellon, Bloomberg*

**T-bill and Chill?**

Our new expanded iFlow for fixed income has been released, and – among other enhancements – we are now able to separate out more granular maturity buckets for US sovereign bonds (see [here](#) for a discussion of some of our findings related to US fixed
income). In the past, our shortest duration sleeve of 0-1y spanned more instruments than just Treasuries. Now, however, we can narrow down sub-1y paper to only Treasuries. The new bucket includes mainly T-bills (also longer-dated bonds now within a year of maturity).

The chart below plots cumulative scored flows into the very front end of the Treasury curve, setting Oct. 4, 2022 to zero. Then, for every day for which we have data, we sum the incremental daily flows. Note the behavior. From the beginning of 2023 and for most of H1, real money investors had been shedding short-dated paper. This trend picked up steam from March through the end of May, as the impending debt ceiling impasse became a major issue. Bills were in short supply given the borrowing constraint on the US Treasury. Recall that the debt ceiling had already been reached in January, and the Treasury thereafter resorted to “extraordinary measures” until the standoff was resolved at the very end of May. After that, rising bill supply and higher rates associated with the increase in paper brought to market led to a significant and swift re-loading of T-bill positions.

What’s interesting to us – and without this unique data set possibly might have gone unnoticed – is that since the end of August, demand has flattened out; real-money long-only investors appear to be once again eschewing the front end, although they haven’t been selling. “T-bill and chill” may have reached its saturation point over the last month-and-a-half.

**Demand Returns – And Stabilizes**

![Cumulative flow: short maturity sovereign bonds](chart.png)

*Source: BNY Mellon Markets, iFlow*

*Please direct questions or comments to: iFlow@BNYMellon.com*
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