Is the Bond Market Fighting the Fed?

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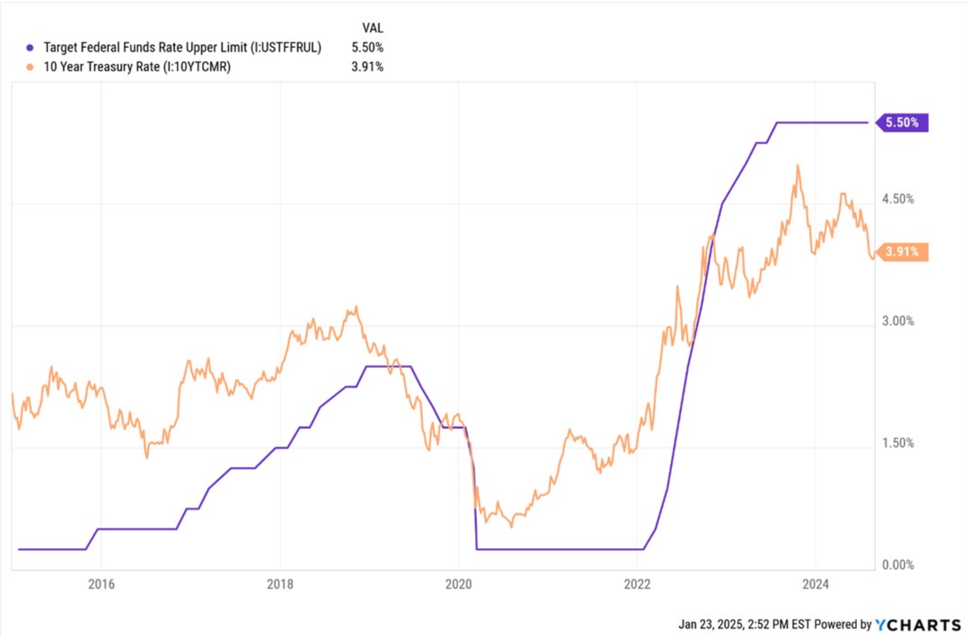
Before I get into what's been going on in the bond market lately, let's quickly go over the past 4 years of Federal Reserve (Fed) interest rate movements: (2)

- February 2022: The Fed continues to maintain that the recent bout of inflation is "transitory" due to the COVID pandemic constraining supply chains.
- March 2022: The Fed finally admits that inflation isn't going away on its own, and hikes their Federal Funds Interest Rate by 25bps, to 0.5%.
- April 2022 through July 2023: The Fed embarked on a brisk rate hiking campaign, increasing the Federal Funds Rate to 5.5%, all the way from the 0.25% it was in February of 2022.
- July 2023 through August 2024: The Fed paused their hiking campaign, maintaining that the current level of 5.5% was "sufficiently restrictive" in order to bring inflation back down to their 2% target.
- September 2024: The Fed decided that inflation had sufficiently cooled, and kicked off their rate cutting campaign with a splash, cutting rates by 50bps, when most experts were expecting only a 25bp cut.

This is where our tale begins...

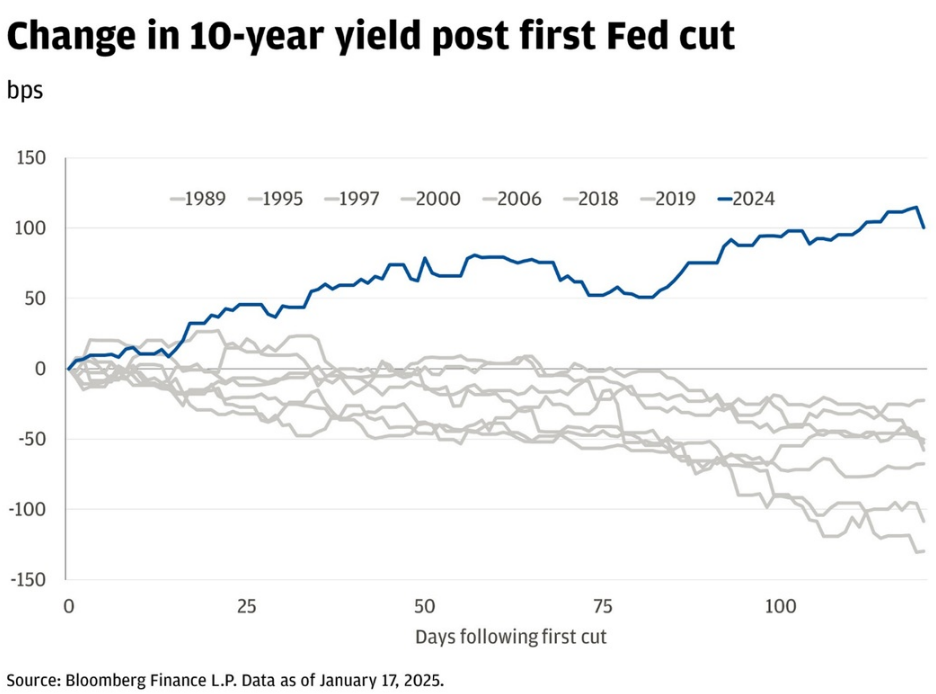
First, let's begin with a simple fact of life: the 10yr US Treasury bond yield tends to track movements in the Federal Funds Rate quite closely. But you don't have to take my word for it, here's a chart that details that very phenomenon: (4)



It's by no means perfect. There are times where the 10yr yield will lead or lag the Federal Funds rate, but for the most part, when the Fed makes a rate cut, the 10yr yield drops along with it.

This time, however, is different. It's now been over 100 days since the Fed kicked of its rate cutting campaign, and they've lowered the Federal Funds rate by a full percentage point. So what's been going on with the 10yr yield since then, you ask? Well, it's flipped the script and risen by nearly a percentage point in its own right. (3)

That's not such a big deal, right? I mean, I just told you that there are times where the 10yr will lead or lag the Federal Funds rate, this must be one of those times. Well, truthfully, it's likely too early to tell if this is one of those cases, but what I can definitely tell you, is that this recent uptick in 10yr yields is extremely strange compared to other rate cutting cycles.



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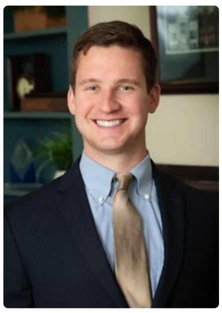

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Schedule a meeting

Ignoring 2024, and since the 1980's, 100% of Fed rate cutting cycles have resulted in lower 10yr yields by day 100. (1) This cycle doesn't just challenge that norm, it flips it on its head. The 10yr yield isn't just not lower, it's noticeably higher.

Okay, so we've determined that the 10yr yield is doing the opposite of what we'd expect, but the real question is why? Well, there are a few reasons why the 10yr yield rises or falls:

- The bond market is expecting the Fed to raise or cut rates, and the 10yr yield rises or falls on those expectations.
- The bond market is expecting increased or decreased economic growth, and the 10yr yield rises or falls on those expectations.
- The bond market is uncertain about one of the two above factors, and rises or falls based on which way that uncertainty leans.

Great, now that we have that out of the way, we just have to figure out which of those three is the culprit. Well actually, it's not that easy either. In reality, it's a combination of all three of those factors, and the actual question is which of the three is the main driver?

The first of those three is monetary policy expectations, or whether the Fed is going to raise or cut rates. This is an easy place to start, because as we saw earlier, the 10yr yield tends to rise or fall with the Federal Funds rate. This doesn't quite explain the recent rise in 10yr yields though, because while the Fed governors have a fair bit of disagreement as to where exactly rates will end up, there does seem to be broad agreement that the direction is down, not up. Typically that would be indicative of decreasing 10yr yields, not increasing.

So let's look to economic expectations instead. 2024 saw the US economy continually outpace expectations, even as the Fed left rates higher for longer to try and tamp down inflation. This economic outperformance has left the bond market wondering if the Fed will continue to leave rates higher for longer, rather than lowering them further as initially expected. As of October 4th, 2024, the CME Group gave nearly 85% odds that at the January Fed meeting, the Federal Funds rate will have been cut to between 3.75% and 4.25%. As of January 24th, those odds are now under 2%. (5) Rapidly, the bond market decided that the Fed is probably going to keep rates where they are for the time being.

So what'd that mean for the 10yr yield? Well, it had been steadily decreasing for a few months in anticipation of the Fed cutting rates (2) (remember how it sometimes leads the Federal Funds rate?), but then the economy kept growing faster than expected, and the bond market decided that maybe they'd gone too far. So September comes around, and the Fed actually starts to make those interest rate cuts, but the market is still worried that they went too far. So rather than dropping along with the Federal Funds rate, it starts to tick back up. Over the next few months, the economic data kept coming in hot, and the bond market kept thinking that maybe it went too far. So what really happened, is that continually positive economic data made the market question the path it had initially expected the Fed to take, and the recent increase in 10yr yield is partially due to those expectations being walked back. It's worth noting that no one really thinks the Fed is planning to raise rates again, but now no one is really expecting them to cut rates either, at least not for a while.

Now let's talk about uncertainty. Though, to be honest, we sort of already did talk about uncertainty. The market is uncertain about the Feds path forward (though not the direction of that path), and the market is uncertain about the economy. Back in October, the consensus was that rates were going to keep getting cut. Now the consensus is that rates probably aren't getting cut. At the start of 2024, the consensus was that the economy would grow by around 2%. Now the consensus is that the economy actually grew by closer to 3%. (1) Both of those miscalculations led to the 10yr yield falling a bit too far before the Fed started cutting rates, and are now leading to it rising while the Fed tries to figure out the path forward.

So is the bond market fighting the Fed? Well, it depends on how you look at it. Yes, the bond market has pushed the 10yr yield up while the Fed has cut the Federal Funds rate. And on the surface, that looks like the market is fighting against the Feds plans to lower rates, keeping them higher even as the Fed drives them lower. Dive a little deeper though, and it looks more like the market is repricing its initial expectations as more economic data comes in, which is more like a bet on what the Fed is planning to do than a fight against what it's already doing.

1) https://privatebank.jpmorgan.com/eur/en/insights/markets-and-investing/tmt/why-have-bond-yields-risen-since-the-fed-started-cutting-rates

2) https://fred.stlouisfed.org/series/DFEDTARU

3) https://fred.stlouisfed.org/series/DGS10

4) https://ycharts.com

5) https://www.cmegroup.com/markets/interest-rates/cme-fedwatch-tool.html

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