July 8, 2022

MARKET SIGHT LINES

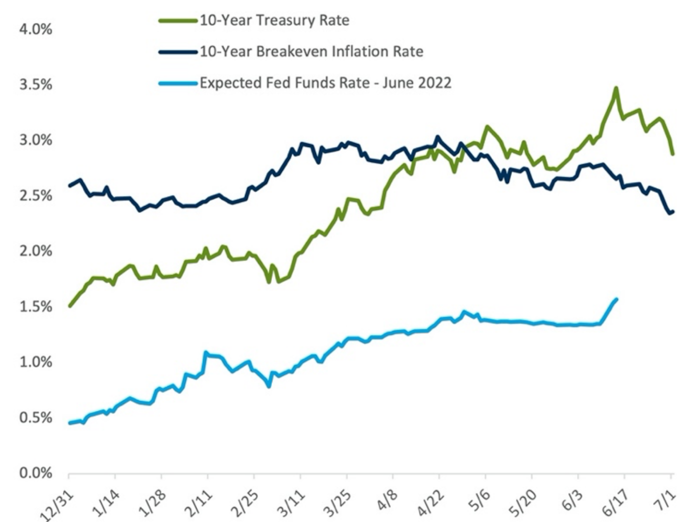
Market Rates Are Falling Some: Positive Relief or Trouble Ahead?

By Michael O'Keeffe, *Chief Investment Officer*

Market interest rates have risen meaningfully in 2022. The 10-year Treasury rate started the year around 1.5%, climbing to about 3.5% in mid-June. With this, bond prices fell, and the bond market, as measured by the Bloomberg Aggregate, posted a year-to-date return of -12.7% over that period. Higher rates have also been a headwind for equities, with the S&P 500 returning -21.1% over that same period. Of course, market rates are influenced by anticipated Federal Reserve (Fed) action, and these days Fed action is affected by elevated inflation.

In this week's Sight|Lines, we unpack this relationship in the first half of 2022, review forecasts for the next 18 months, and then answer the question: Is this positive relief, or is there trouble ahead?

Figure 1: Interest Rates – First Half of 2022



Source: Stifel Investment Strategy via Bloomberg, as of July 8, 2022

MARKET RATES – FIRST HALF 2022

The relationships unfold sensibly when we look at the pattern of rates in the first half of 2022. For the first couple of months, the market participants' 10-year forecast of future inflation hovered around 2.5%. Investors anticipated that the Fed would take modest action during that period, anticipating a fed funds rate of about 1% by midyear. In response, the 10-year Treasury rate was near range-bound between 1.5% and 2%.

In March, the future view on 10-year inflation rose to 3%, and both the anticipated Fed action and the 10-year climbed over the next couple of months, with the expected June fed funds rate settling around 1.5% and the 10-year Treasury rate trading near 3%. In response, the 10-year breakeven inflation fell to just above 2.5%.

But as we approached June, anticipated inflation rose again, and the 10-year Treasury rate jumped to 3.5% in anticipation of further Fed action at later meetings. But then the Fed surprised the markets with a 0.75% hike at the June meeting. This more aggressive Fed policy has translated to a market view that inflation will move closer to the Fed's 2% target over the next ten years, which in turn has caused the 10-year Treasury rate to fall, likely the result of investors believing the Fed may not need to hike rates as much in the future to rein in inflation.

So, where do rates go from here?

MARKET RATES – NEAR-TERM FORECASTS

Figure 2 shares information about rate forecasts. The first two columns address this Fed rate hike cycle. Currently, the futures market forecasts that the cycle will peak in the first quarter of 2023 at 3.25%-3.50%. Stifel's Chief Economist, Dr. Lindsey Piegza, is anticipating a more aggressive rate hike cycle, with the fed funds rate peaking at 3.50%-3.75%. Notably, the futures market and Dr. Piegza expect the fed funds rate to be cut by 0.75% in 2023, but from a higher level, as predicted by Stifel. We discuss the Fed's motivation for cutting its rate, or "easing," below.

Figure 2: Rate Forecasts

	Fed Funds Rate		Forward Rates	
	Futures Market	Stifel Forecast	10Y BE Inflation	10Y Treasury
Current	1.50 %-1.75%	1.50%-1.75%	2.39%	3.07%
Q3 2022	2.75%-3.00%	2.75%-3.00%	2.33%	3.09%
Q4 2022	3.00%-3.25%	3.25%-3.50%	2.29%	3.10%
Q1 2023	3.25%-3.50%	3.50%-3.75%	2.25%	3.11%
Q2 2023	3.00%-3.25%	3.50%-3.75%	2.21%	3.12%
Q3 2023	2.75%-3.00%	3.00%-3.25%	2.20%	3.13%
Q4 2023	2.50%-2.75%	2.75%-3.00%	2.20%	3.15%

Source: Stifel Investment Strategy via Bloomberg, as of July 8, 2022

We are also able to observe market forecasts for future rates. First, inflation is expected to fall from current levels as the Fed implements its rate hike cycle, with the 10-year breakeven inflation forecast falling close to the Fed's 2% target by the end of next year. The market forecasts the 10-year rate will remain close to its current level. Why? The current 10-year Treasury tends to trade in anticipation of these types of future forecasts. So, the recent move down from the recent 3.5% high to today's level of 3.1% likely means that investors are looking through this rate hike cycle to consider the period of easing or lower Fed rates starting next year.

This begs the question: Is this positive relief, or is there trouble ahead?

POSITIVE RELIEF, OR IS THERE TROUBLE AHEAD?

Let's first focus on some positive relief. Since the 10-year Treasury yield's 3.5% peak on June 14, 2022, rates have fallen, helping bond prices recover some. Since then, the Bloomberg U.S. Aggregate Bond Index has returned 2.7%, making up for some of the earlier losses mentioned above. So, this is indeed some positive relief.

Might there be trouble ahead? Many would argue that the Fed will be forced to cut rates in 2023 because the effect of this rate hike cycle will have gone too far, slowing growth and potentially causing a recession. Our colleague Dr. Piegza has forecasted that U.S. GDP will contract 2.1% in the fourth quarter of 2022, leading to a contraction of 0.6% over the full year of 2022. She sees a greater than 50% risk of a recession over the coming year. My team and I are more optimistic, as we explain in Market Volatility: More Storms, Clear Skies, or Both? Much will depend on inflation in the coming few months.

CONCLUSION

Market interest rates have risen in 2022, which caused a drop in bond prices and also presents a headwind for consumers and businesses as borrowing rates have increased. The Fed has driven this by hiking rates and signaling more. But after the Fed's 0.75% rate hike in June, market rates have fallen, providing some relief. The question remains: Is this positive relief or a sign of trouble ahead? We lean toward the positive.

Michael P. O'Keeffe, CFA

Chief Investment Officer

michael.okeeffe@stifel.com

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), and ABS and CMBS (agency and nonagency).

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

0722.4835475.1