AST DEFEASANCE RATE MARKET UPDATE

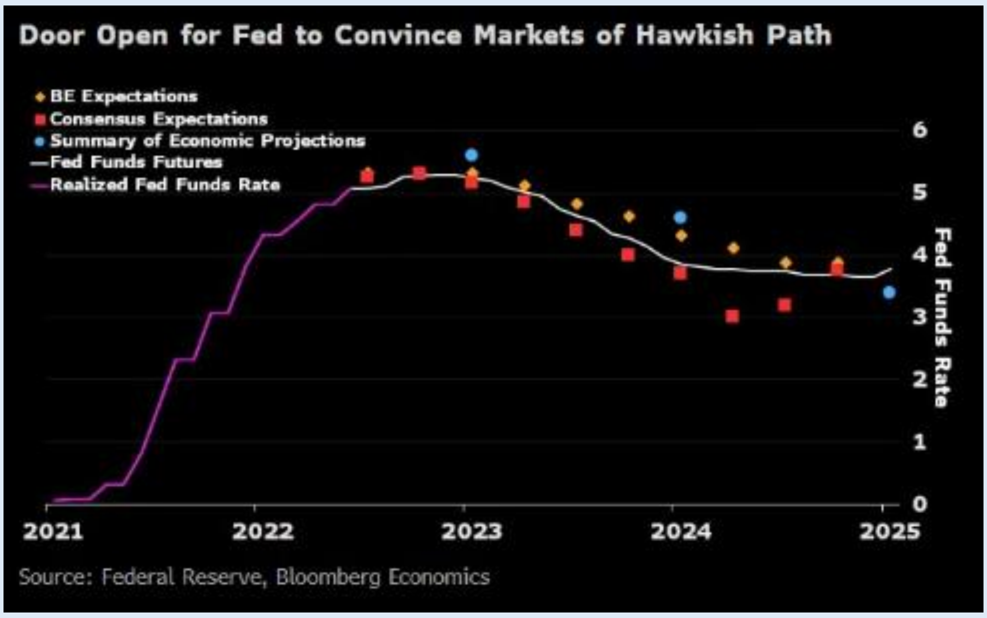
MARKET FLASH REPORT: June 21, 2023 | *Mr. Powell Goes to Washington D.C.*

- **FOMC Chairman Powell delivers his semi-annual testimony to Congress today and tomorrow**
- **Testimony will focus on monetary policy and the economy**
- **The format is a prepared statement by Powell, followed by Q&A**
- **Jobless Claims, Existing Home Sales data released tomorrow morning**

Fed Chair Jerome Powell is due to give his semi-annual report to Congress today and tomorrow, where he is anticipated to take a hawkish tone and reiterate warnings that higher rates may be needed and needed for longer, to combat inflation. While Fed policymakers left interest rates unchanged at their policy meeting last week, their updated forecasts imply around two additional quarter-point rate hikes or one half-point increase this year. Since then, money markets have been attaching ~80% odds to a quarter percentage point hike in July. While Powell's immediate audience today and tomorrow will be US lawmakers, his message will be aimed at financial markets, which remain unconvinced the Fed will hike by another 50 basis points, as indicated in the dot plot from the June FOMC meeting. Powell may step-up his hawkish tone to push back against such views. This morning, Powell reiterated that the central bank is "strongly committed" to bringing inflation back to its 2% goal in prepared remarks ahead of House testimony later this morning. That is a fresh and concise reminder the fight against inflation still has a long way to go – the market would be wise to heed this reminder. Nothing the FOMC has said in recent weeks leads me to believe the fight against inflation is over and there is no indication that the FOMC is preparing to cut rates anytime soon.

Powell's testimony could certainly create some rate volatility – the degree of volatility will depend on what he says and more importantly, what the market *hears*. As Powell has stated many times in recent months: "Restoring price stability is essential to set the stage for achieving maximum employment and stable prices over the longer run." Powell's testimony the House begins at 10:00am this morning, followed by testimony to the Senate tomorrow at 10:00am. Stay Tuned!

CHART 1: FOMC vs. "The Market"



Source: Bloomberg, LLP

The Bloomberg table above provides a snapshot of market and FOMC expectations for the overnight Fed Funds rate. You can see from this graph that the market has definitely "moved toward the Fed" over the past month or so, but there is still a noticeable dichotomy between market expectations and FOMC projections. The FOMC dot plot (blue dots) contemplates the possibility for another 50 basis point rate hike – in one shot or two 25 basis point hikes. Economists (yellow triangles) track closely to the Fed, but the market remains the outlier. The market is still skeptical that the Fed will raise rates again, or even hold them here for any length of time. As such, the market is holding out hope for rate cuts later this year, and Fed Funds futures trading still bears this out (white line). As we know, the Fed has been adamant that no rate cuts are on the table for this year and that the possibility exists that additional monetary policy firming will be necessary (Translated: more rate hikes!). Powell's testimony presents the perfect opportunity to shift market sentiment more towards the Fed's rate bias. I am not sure he will succeed.

Thus far this morning the market has crept higher – SOFR swap rates are up ~5 basis points across the swap curve. Implied volatility remains steady, but volatility could definitely move high during Powell's testimony.

<u>CHART 2:</u> 2y, 3y, 5y, 10y SOFR Swap Rates: *Prior 30 Days*

Source: Bloomberg, LLP

You can see from the above Bloomberg graph that Fed sensitive short-end (2y, 3y) SOFR swap rates have moved steadily higher since the last Fed meeting on fears the Fed may need to raise rates again at either the July 26 or September 20 meetings – or both. (The FOMC does not meet in August). However, as you can see the market is still not convinced this is the right path forward for the Fed. Evidence of that can be seen in the way 5y and 10y SOFR swaps have been trading. Longer term rates have hovered in a range and unlike shorter term SOFR swap rates, have not increased materially. The market appears to believe the Fed would be making the wrong decision by raising rates further and that has once again increased fears the FOMC's aggressive and sustained rate hikes will push the economy into recession. This is also the primary reason we have seen the yield curve inversion deepen since the last Fed meeting. *Stay tuned!*