BONDS

How to Prepare for Landing

March 2, 2023 Kathy Jones

A "soft landing," with declining inflation but positive growth, would be ideal. However, turbulence appears likely. Here's how to handle it.

Aviation metaphors are popular in the financial markets. References to headwinds and tailwinds affecting economic growth and markets are common. Recently, economists have been debating whether the economy is headed for a "soft" or "hard" landing. There are no precise definitions of these potential outcomes, but in general a soft landing is seen as a moderate slowdown in the economy followed by renewed expansion, while a hard landing is characterized as a recession with rising unemployment amid significant economic weakness. There's even talk about a "no landing" scenario, but that just seems like a way to describe a delayed landing. After all, there is always some sort of landing.

In keeping with the aviation theme, the debate brings to mind a saying among pilots: "Any landing you walk away from is a good landing." In other words, if you can survive the landing intact and without injury, you've succeeded. We see that as a worthwhile perspective for investors. It's more important to survive the landing than to guess its force.

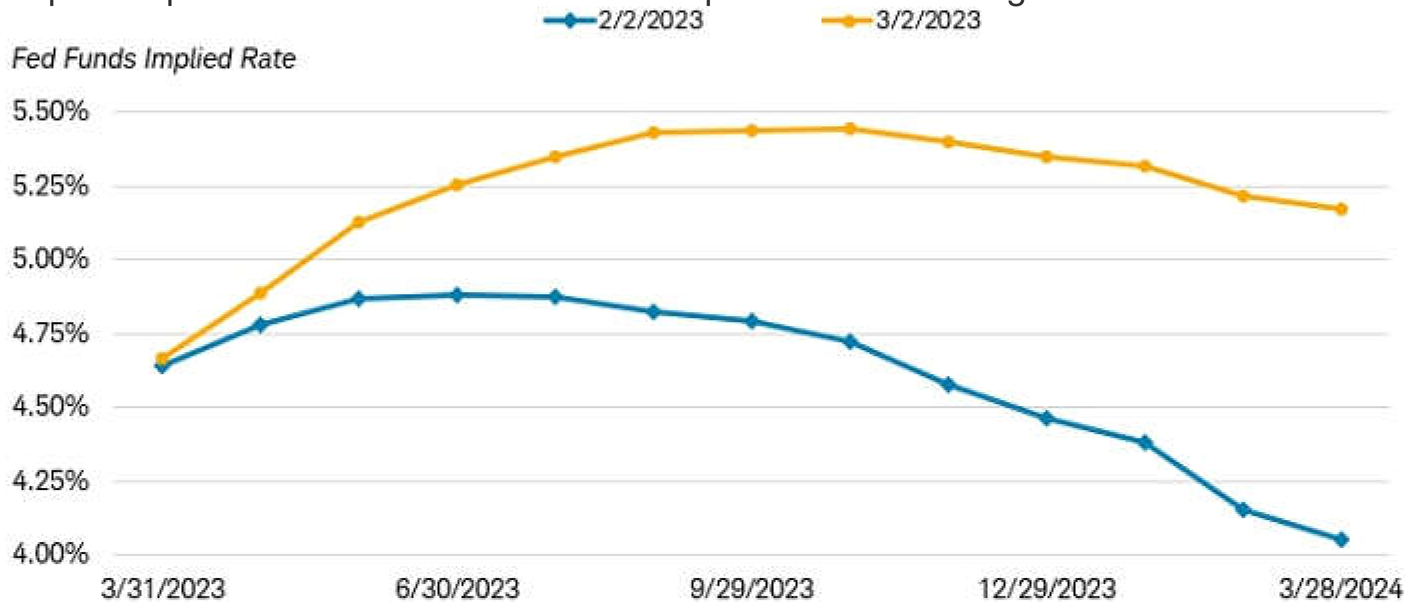
Risk of a hard landing is rising

We aren't committed to any particular landing scenario, but the prospect of the Federal Reserve continuing to tighten monetary policy over a longer time period raises the risk of recession. Over the last year, the Fed has raised the federal funds rate—its benchmark short-term rate—at the fastest pace since the early 1980s and reduced its

balance sheet holdings of bonds by about $550 billion. Moreover, the Fed is continuing to signal that more rate hikes are likely to come due to the resilience in the economy and the persistence of inflation pressures.

Not surprisingly, expectations for where the federal funds rate will peak continue to rise. The market is currently pricing in the potential for the rate to go as high as 5.25% to 5.5% this year—up 50 basis points (or 0.50%) in the past month alone. Some Federal Reserve officials have even indicated that short-term rates may need to rise to 6% to slow economic growth and cool inflation. That is likely a "hard landing" scenario.

Expected path of the federal funds rate compared to a month ago



Source: Bloomberg

Market estimate of the federal funds rate using Fed Funds Futures Implied Rate (FFM2 COMB Comdty). As of 2/1/2023 and 3/1/2023, respectively.

How hard will the Fed hit the brakes?

Investors will get more insight into the Fed's plans at the upcoming March 20-21st meeting when it releases its updated Summary of Economic Projections. While there are some expectations that the Fed could increase the size of the next rate hike to 50 basis points from the recent pattern of 25 basis point hikes, we doubt that will happen.

In our view, the most likely outcome is another 25-basis-point hike in the target range for the federal funds rate, bringing it to 4.75% to 5.0%. Having just reduced the size of its rate hikes in January, we doubt the Fed will want to shift gears again so soon. However, the median estimate for the peak fed funds rate—often referred to as the terminal rate—could rise as the Fed assesses how much more tightening is needed to slow inflation.

Nonetheless, because changes in monetary policy can take a long time to affect inflation, it makes sense for the Fed to slow down the pace of rate hikes after a year of aggressive tightening. Moreover, there are signs that policy is already "restrictive"—tight enough to slow economic growth and reduce inflation.

Here's what we're seeing on the horizon

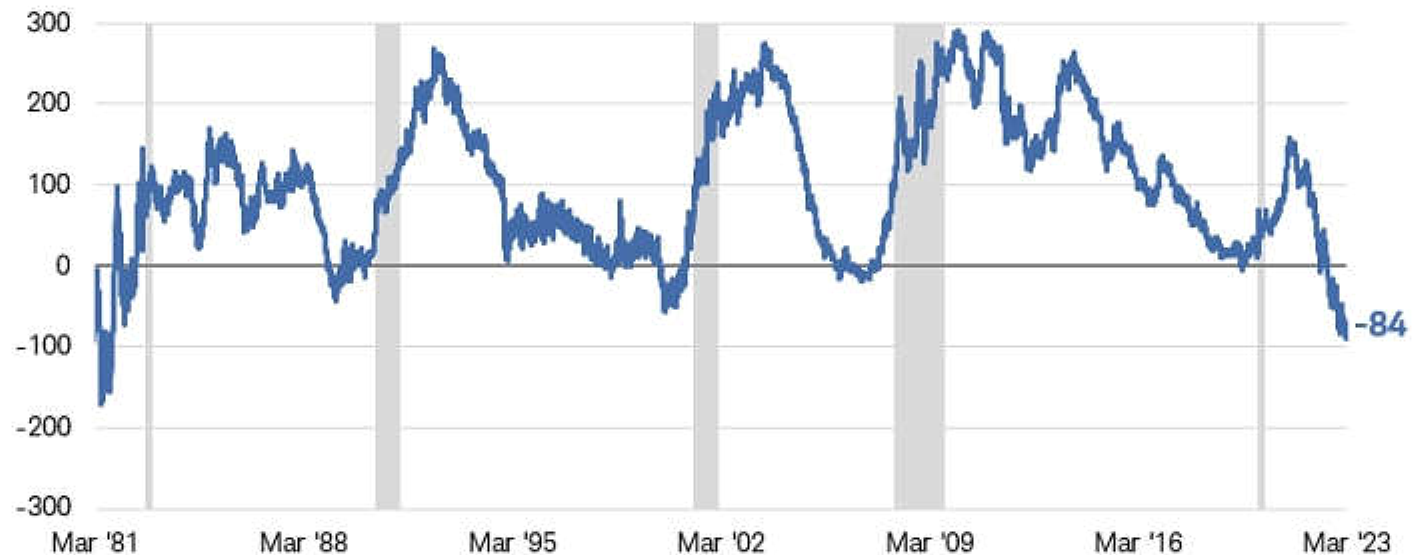
1. Inverted yield curves

Yield curves are inverted across the Treasury market—with short-term rates significantly higher than long-term rates. With each rate hike the yield curve has become more inverted—with short-term rates significantly higher than long-term rates.

The spread between two-year and 10-year Treasury yields has fallen to nearly minus-90 basis points, the deepest inversion since the 1980s. In the past, an inverted yield curve has been a reliable indicator of recession within 12 to 18 months. However, the severity of a recession has varied and hasn't correlated to the depth of the inversion.

The yield spread between 2-year and 10-year Treasuries is deeply inverted

2-year/10-year yield spread (basis points)



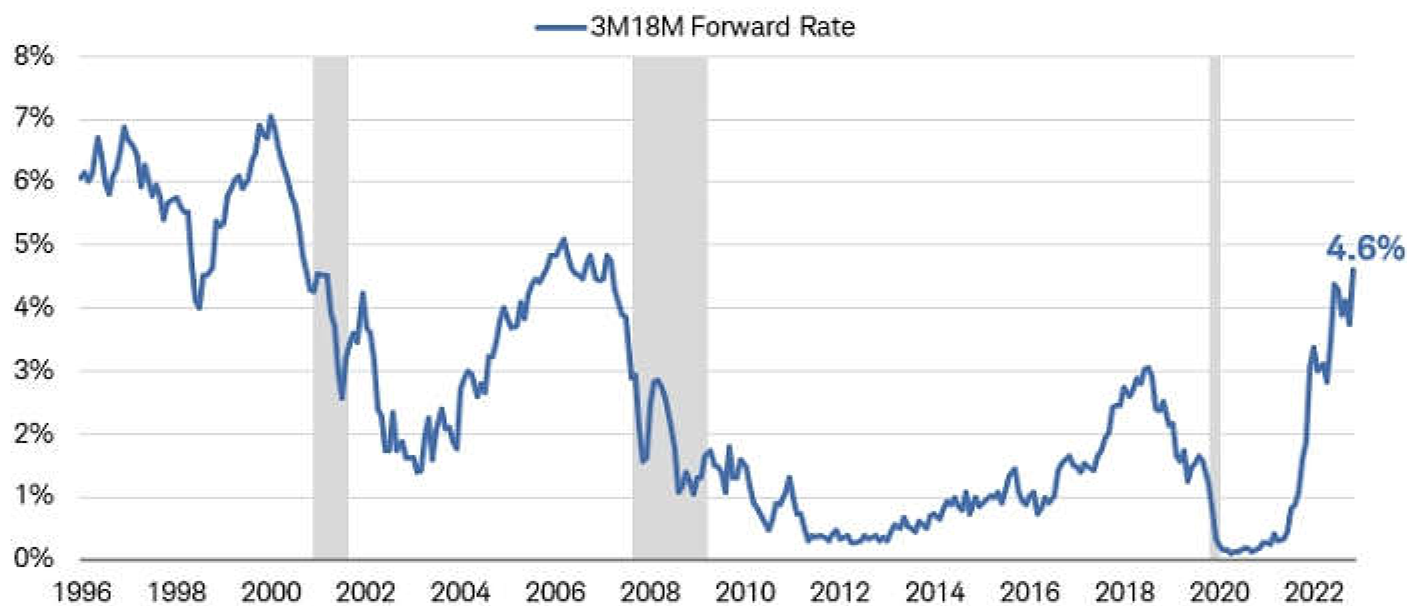
Source: Bloomberg. Market Matrix US Sell 2 Year & Buy 10 Year Bond Yield Spread (USCY2Y10 INDEX). Daily data as of 3/1/2023.

The rates are composed of Market Matrix U.S. Generic spread rates (USYC2Y10). This spread is a calculated Bloomberg yield spread that replicates selling the current 2 year U.S. Treasury Note and buying the current 10 year U.S. Treasury Note, then factoring the differences by 100. Gray bars indicate past recessions.

Historically, an inverted yield curve should result in a slowdown in lending activity. Banks and other providers of financing tend to borrow at short-term rates and lend at longer-term rates, earning the difference or spread. With short-term rates significantly higher than long-term rates, lenders drive up the cost of borrowing and/or reduce the amount of capital they are willing to provide.

Even the Fed's preferred yield curve indicators—the "forward curve," or the spread between current three-month yields today and the implied yield on three-month yields a year and a half from now—is pointing to a rising risk of recession. At 4.6%, it is the highest since 2007.

The "forward curve" is suggesting a rising risk of recession



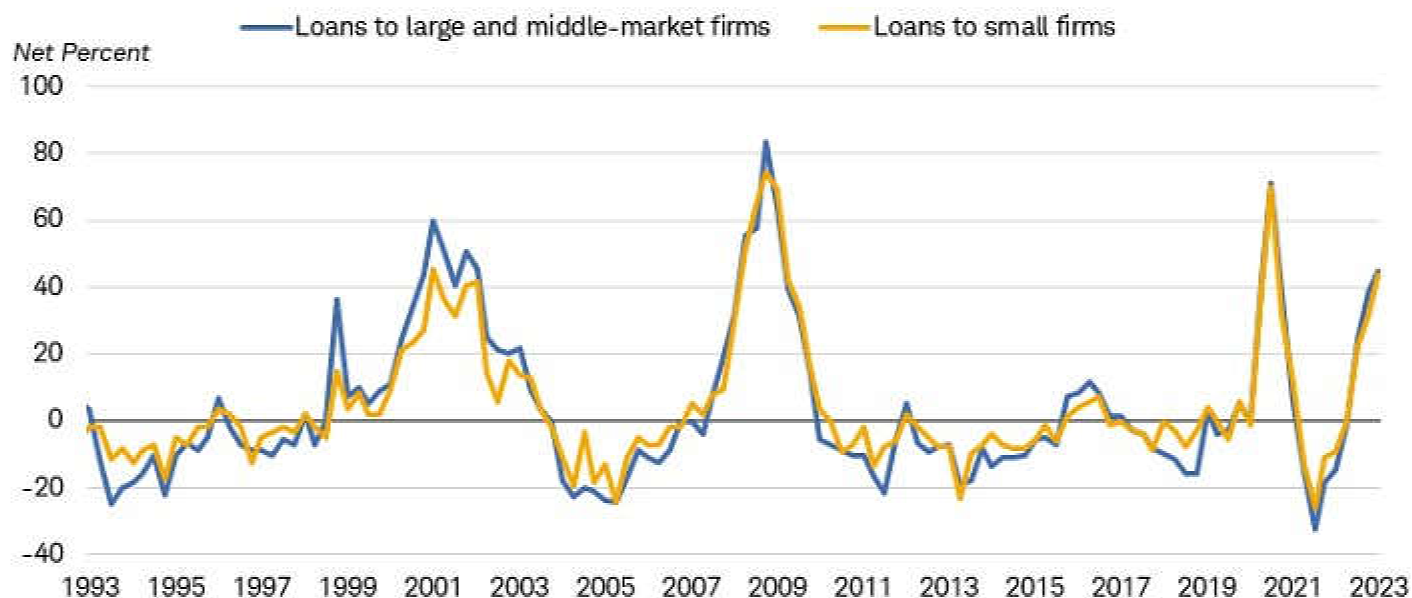
Source: Bloomberg. USD OIS FWD swap 18M3M (G0025 18M3M BLC2 Curncy). Daily data as of 3/1/2023.

Gray bars indicate past recessions. A vanilla interest rate swap is an agreement between two counterparties to exchange cash flows (fixed vs floating) in the same currency.

2. Tightening lending standards

Since the goal of tighter policy is to push up the cost of capital by enough to restrict economic activity on the part of businesses and consumers, it's notable that lending standards are tightening for both businesses and consumers.

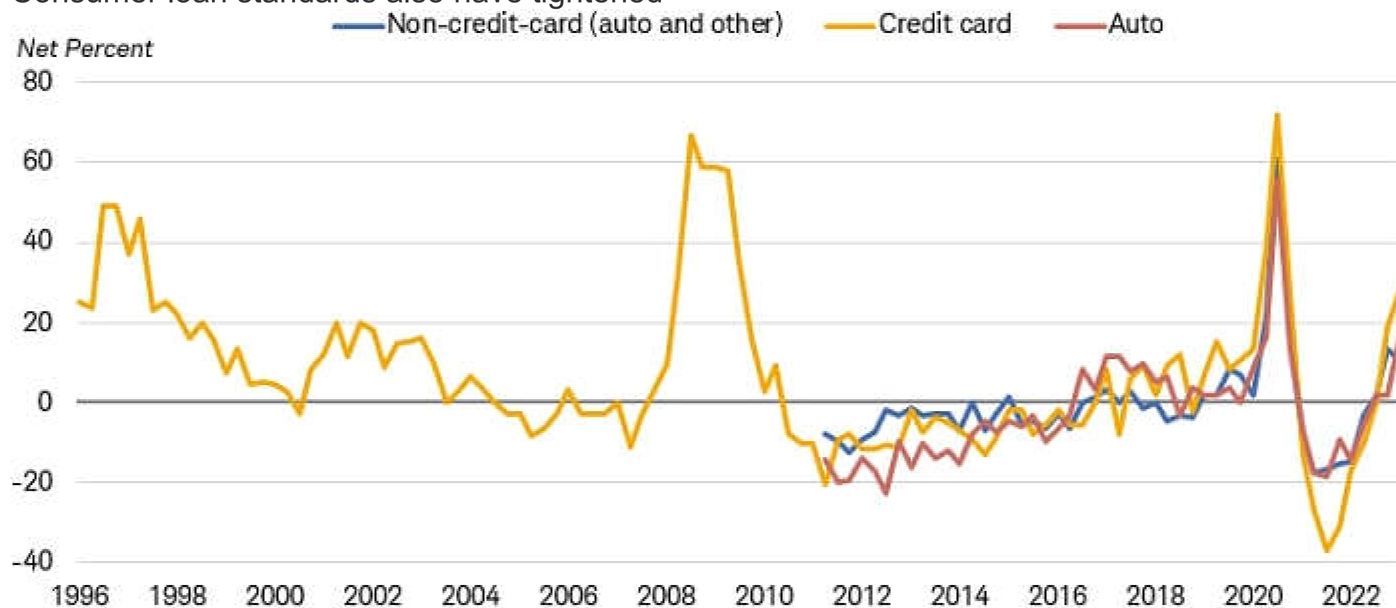
Commercial and industrial (C&I) loan standards have tightened



Source: Bloomberg. Quarterly data as of January 2023.

Federal Reserve's Senior Loan Officer Survey: Net Percent of Domestic Respondents Tightening Standards for Commercial & Industrial Loans for Large/Medium Sized Firms and Small Firms (SLDETIGT Index, SLDETIGTS Index.

Consumer loan standards also have tightened

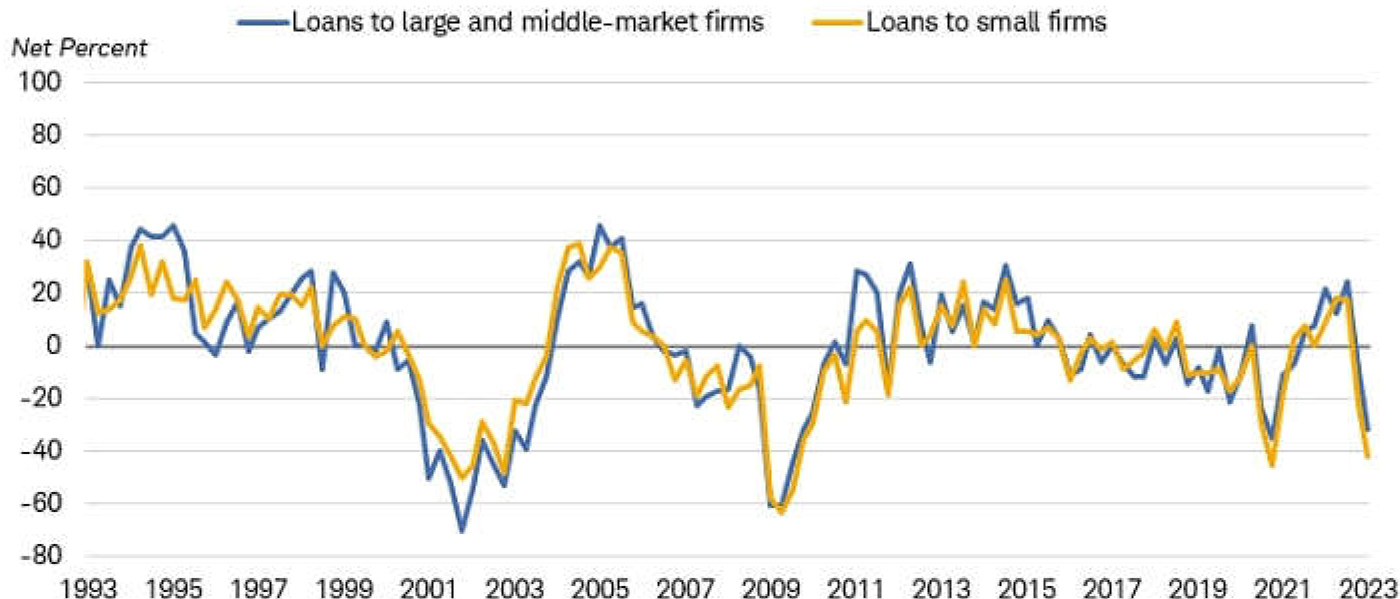


Source: Federal Reserve's Senior Loan Officer Survey: Quarterly data as of January 2023.

Net Percentage of Domestic Respondents Reporting Tightening Standards for Consumer Loans (STDSOTHCONS, DRTSCLCC, STDSAUTO).

Not surprisingly, demand for loans is declining as consumers and businesses become more cautious about borrowing at higher rates. A slowdown in consumption, investment and hiring is likely to follow.

Demand for C&I loans has declined



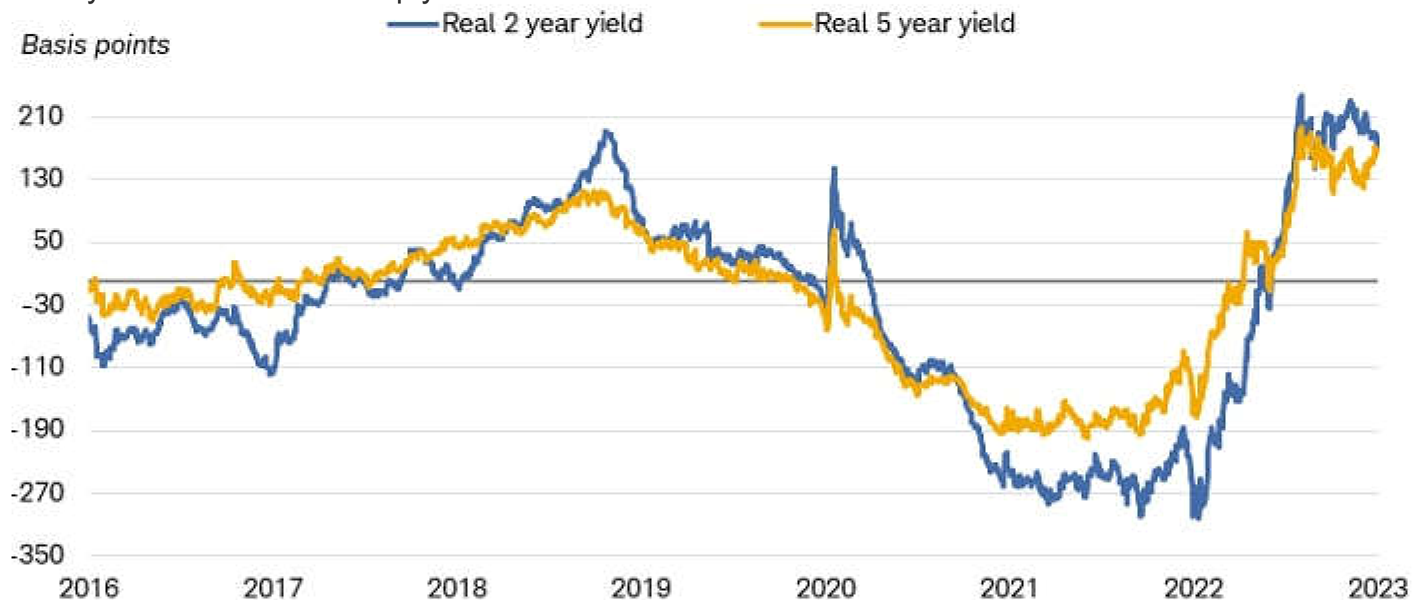
Source: Federal Reserve's Senior Loan Officer Survey: Quarterly data as of January 2023.

Net Percentage of Domestic Respondents Reporting Stronger Demand for Commercial and Industrial Loans for Large/Medium Sized Firms and Small Firms (DRSDCLIM, DRSDCIS).

3. Real yields have moved up sharply

The sharp rise in real yields—yields adjusted for inflation expectations—suggests policy is tight. Current two- and five-year real yields are higher than the most recent peak in 2019, when the Fed reversed its last rate hiking cycle. In fact they are at the highest levels since 2009.

Real yields have risen sharply



Source: Bloomberg. US Generic Govt TII 2 Yr (USGGT02Y INDEX), US Generic Govt TII 5 Yr (USGGT05Y INDEX).Daily data as of 2/28/2023.

Past performance is no guarantee of future results.

Higher real yields make it more expensive for businesses to invest and consumers to spend, while making holding fixed income assets more attractive.

A good landing

The best-case scenario would be that one where inflation continues to recede while economic growth and employment continue to stay positive. However, given what we're seeing on the horizon, we suggest investors should be cautious about risk-taking. More turbulence is likely over the next few months.

The goal should be to walk away from the landing—whatever form it takes—without significant losses or declines in portfolio values. We suggest focusing on bonds high in credit quality, such as Treasuries and investment-grade corporate or municipal bonds, while gradually adding to duration until it reaches your benchmark level. Duration refers

to the sensitivity of a bond's price to changes in interest rates. In general, short-term bonds have lower durations than long-term bonds. A common benchmark duration tracked by fixed income investors is the Bloomberg Barclays Aggregate Bond Index. Its duration is currently about 6.2 years. For investors who are more risk-averse and holding a significant amount of fixed income in very short-term maturities, we suggest moving out to at least two- to three-year maturities to avoid reinvestment risk—that is, the risk of being forced to reinvest at a lower yield while yields are dropping. In past cycles, when the peak in rates has been reached, yields have tended to fall quickly as the market adjusts its expectations for the path of Fed policy and inflation.

Overall, whether it's a hard or soft landing, yields are likely to decline. In the meantime, we would be prepared for a bumpy ride.