
Reading Fed Tea Leaves? Watch Market Prices Instead

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Fed watching is once again one of the markets' favorite pastimes. Fed officials continue to signal that they would favor tapering of bond purchases in 2021, in line with recent announcements from the European Central Bank. When and how remain to be seen. With ample speculation about the Fed, unemployment, and inflation, it might be a good time for a reminder about what Fed announcements can, and cannot, tell us about the future of fixed income markets.

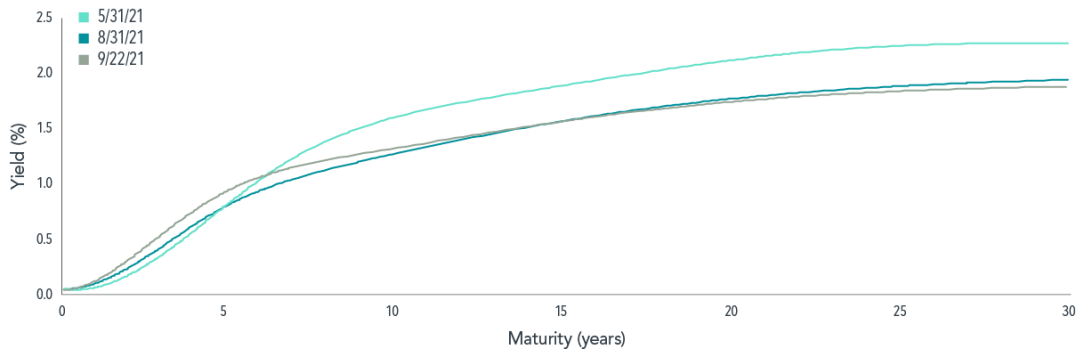
Yields reflect the aggregate expectations of all market participants, including opinions on how and when the Fed will act. And even if a crystal ball could reveal the timing and direction of the Fed's actions, we would not know how broader interest rates would react. The Fed is one of many market participants in a larger ecosystem that impacts yield curves at large.

FED SAYS 'JUMP,' MARKET SAYS 'NOT SO FAST'

At the Federal Open Market Committee meeting in July, Fed officials strongly suggested they would soon slow bond purchases, and they confirmed their intentions at the Jackson Hole Symposium in August. Fed Chair Jerome Powell announced that "a moderation in the pace of asset purchases may soon be warranted."¹ But fixed income markets have responded tepidly, perhaps because market participants already priced in a potential tapering. **Exhibit 1** shows that interest rates generally decreased during the last three months, as opposed to increasing like they did when the Fed announced tapering in the wake of the Global Financial Crisis ("GFC"). This movement may suggest that market dynamics and participants in aggregate, not the Fed alone, determine the level and shape of the yield curve.

Exhibit 1**Hop, Skip, or Jump:
Always Aggregating
Information**

Treasury yield curve,
May 31, August 31, and
September 22, 2021



Source: Barclays

While shorter-term yields rose, longer-term yields fell, a reminder that longer-term yields do not always move in lockstep with changes in the federal funds target rate. **Exhibit 2** shows there have been instances when the Fed increased the federal funds target rate, yet longer-term interest rates decreased. From January 1983 to December 2020, there were 70 months in which the federal funds rate increased. About a third of the time, the increase coincided with a decrease in the 10-year US Treasury yield. The lack of a consistent relation between movements in long-term yields and the federal funds rate reinforces the notion that yield curves reflect all available market information, including any Fed action.

Exhibit 2**A Tenuous Relation**

10-year US Treasury
yield vs. federal funds
target rate, January
1983-December 2020



1. In the United States, the federal funds rate refers to the rate that depository institutions charge each other for an uncollateralized overnight loan of funds. The Federal Reserve sets the target for this interest rate, though market forces can cause variation from the target rate at times.

Source: US Treasury data provided by FRED, Federal Reserve Bank of St. Louis.

Data is subject to change.

Investors should not discount the importance of the Fed and its role in the global financial markets, however. The Fed has many powerful tools to simulate the economy during times of economic distress, as evidenced by its response to the GFC and the COVID-19 pandemic. Still, the Fed does not act in a vacuum. Prices across the broader yield curve are set in conjunction with the aggregate expectations of numerous other market participants.

NO RELIABLE WAY TO PREDICT FUTURE INTEREST RATES

Investors don't need to dedicate time or resources to predicting the Fed's next move. Rather, decades of empirical research provide a framework for understanding how to use information in market prices and diversification to pursue higher expected returns and improve the reliability of outcomes.

Larger differences in forward rates among bonds of different durations, credit qualities, or currencies of issuance can indicate larger differences in expected returns. Using market information available in global yield curves is a more reliable way to improve expected returns than trying to read the Fed's tea leaves.

1. ["Federal Reserve Issues FOMC Statement,"](#) Federal Reserve, September 22, 2021.

This material is in relation to the US market and contains analysis specific to the US.

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