Like a Toddler Taking Their First Steps

Back on June 4th we wrote that the Fed was going to start playing a smaller role in the markets. Everything that I see from yesterday confirms that view.

- **Very high hurdle to cut rates**. Given that the SEP dots plot nudged up across the board, it demonstrates a commitment to talk tough. However, the terminal rate remained at 2.5% (based on the median, though the average did tick higher). At no point in the next 6 months is the market pricing in a Fed Funds Rate lower than today. **No cuts.**
- **High hurdle for significantly more hikes.** Yes, while 25 bps at the next meeting is the "base" case, we would need incredibly strong jobs and inflation data to get more than 25 bps. Housing, due to the way it is incorporated into CPI, will help on the inflation front as weakness from last autumn will finally start showing up in the "official" data that policy makers (bizarrely) seem to rely on. Then, unless data reflects some real resurgence of inflation and growth (completely contrary to the anticipated slowdown), they are unlikely to hike at back-to-back meetings, unlikely to do 50 bps, and unlikely to get to 6%. **Small sporadic hikes if anything.**
- **Balance sheet reduction is on cruise control**. My perception is that the Fed spent about 10 seconds on balance sheet reduction. No one has any interest in reducing the size of the balance sheet reduction effort. Powell did say that it continues at a significant pace, though I'd call it more moderate than fast. No one seems to have any interest in increasing that pace. **Balance sheet reduction will remain at a largely manageable pace for months to come.**

So, for the first time in years, I find it difficult to believe that any one or even any series of Fed speakers can move the markets by much. Also, any single data point is unlikely to move markets. By and large, the Fed (like a parent) is finally letting the markets try to walk on their own.

Yes, the Fed is still important, but other narratives will have a chance to rise to the top and shape markets.

Bottom Line

We should see reduced volatility in the rates market. The MOVE index is still above 100 (it was briefly below this level at the end of January). With Fed policy by and large on hold, we will see rates react to data and supply/demand issues, which is all "normal" behavior. This will lead to a lower MOVE index (VIX is already at multi-year lows).

The 2s vs 10s spread could continue to invert. This inversion has been my favorite trade in the rates market, but at -92 bps (where it currently is) we've already seen quite a large move. **With the 2-year potentially "anchored", that trade will look more and more like an outright bet on 10s**.

On rates, watch for moderately higher yields with 2s vs 10s getting less inverted (which is a change in my view).

For equities, the big question as a contrarian is how much money got plowed into the market betting on the Fed being done? Whether it is the Rule of 3 or "by the time my mother knows", we need to find out if investors are loaded up on stocks and waiting gleefully for others to buy the "pause" or not. My concern is that this trade was so popular that now there is little money left to chase the pause. Yesterday's trading still seemed to cling to every word that Powell uttered (it will take a while for this market to learn to walk on its own), but I don't see a panic by any remaining bears. If anything, I see some disappointment from bulls who are looking at futures and hoping that we'd see further gains.

Without the "Fed is done" catalyst and signs of markets being overbought, look for some weakness as the "new" drivers and narratives take shape and form.

Look for credit spreads to give up some recent gains. CDX is a wildcard and compared to equities and VIX it looks cheap, so it should outperform those asset classes. However, since it tends to be better correlated with equities, it should underperform corporate bond spreads. These spreads could see some support from reduced issuance by corporates. However, the need to issue by regional banks could create more supply this summer than previously expected.

Three Quick Notes

Away from those market views, Academy's travel and client calls continue at a record pace. One thing that seems to be coming up in these engagements is **more and more questions about our domestic politics.** I am not sure what is going on (and it isn't at every meeting), but "domestic focused issues" seem to be cropping up alongside China and Russia as areas of concern.

Our first AI webinar will be next Thursday (June 22nd) at 11am ET (register here). General (ret.) Groen and Admiral (ret.) Barrett are leaders in the field and have utilized their military experiences to work with companies across the globe. I get to ask questions that as a market participant I'm desperate to know the answers to!

On Friday, Academy will guest host Bloomberg Surveillance again from 6am to 7am ET – guess last Monday's guest hosting experience wasn't bad enough to get me kicked off 😊.

Have a great long weekend! Stocks tend to like trading higher into long weekends, so if we don't get that it will be another sign that these first steps without the Fed's guiding hand could be bumpy. However, I am still so happy that the Fed should play a reduced role in market moves for the coming months!

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