Thackray Report

The Bond Market does a better job than the Federal Reserve !

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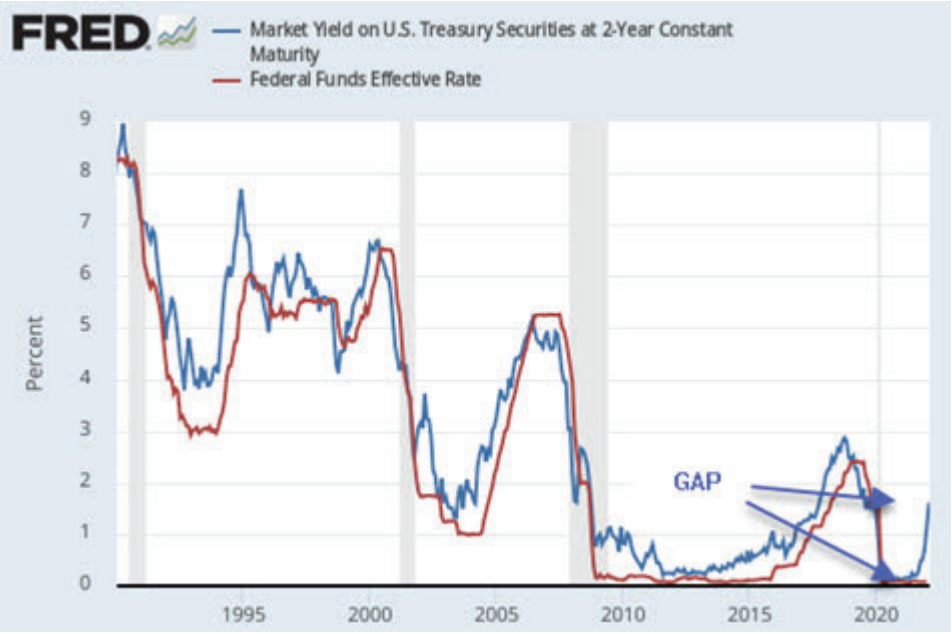
The Federal Reserve is behind the curve. The yield on the 2 Year US Treasury Note is indicating that the Federal Reserve needs to take action soon.

Most investment media pundits are expecting the Federal Reserve to start increasing the federal funds rate starting in March 2022, but how high will they go, or how high should the go? The Federal Reserve has been giving confusing guidance on this topic. In November of 2021, the Federal Reserve governors in their speeches across the country, collectively took on a more hawkish tone, moving the stock investors to believe that six possible rate hikes could take place in 2022.

Starting in 2022, the Federal Reserve started to pull back on their guidance, communicating that they were backing off a bit on their hawkish position. Now that the January CPI number was higher than expected, coming in at 7.5%, the Federal Reserve will probably move to a more hawkish position. This back and forth by the Federal Reserve is confusing and sending mixed messages to investors. At what level should the federal funds rate be set? Just ask the bond market. The yield on the 2 Year US Treasury Note has historically been a good indicator of where the federal funds rate should be set by the Federal Reserve.



The Federal Reserve controls the short end of the yield curve (the shorter duration notes and bonds). The further out on the curve, the more difficult it is for the Federal Reserve to control the yield. The Federal Reserve does have some control of the 2 Year US Treasury Note, but investors also play an important part in setting this rate as it is a blend of federal funds rate expectations, inflation expectations and growth expectations. Investors tend to push the 2 Year US Treasury Note yield to where the federal funds rate should be at a minimum.

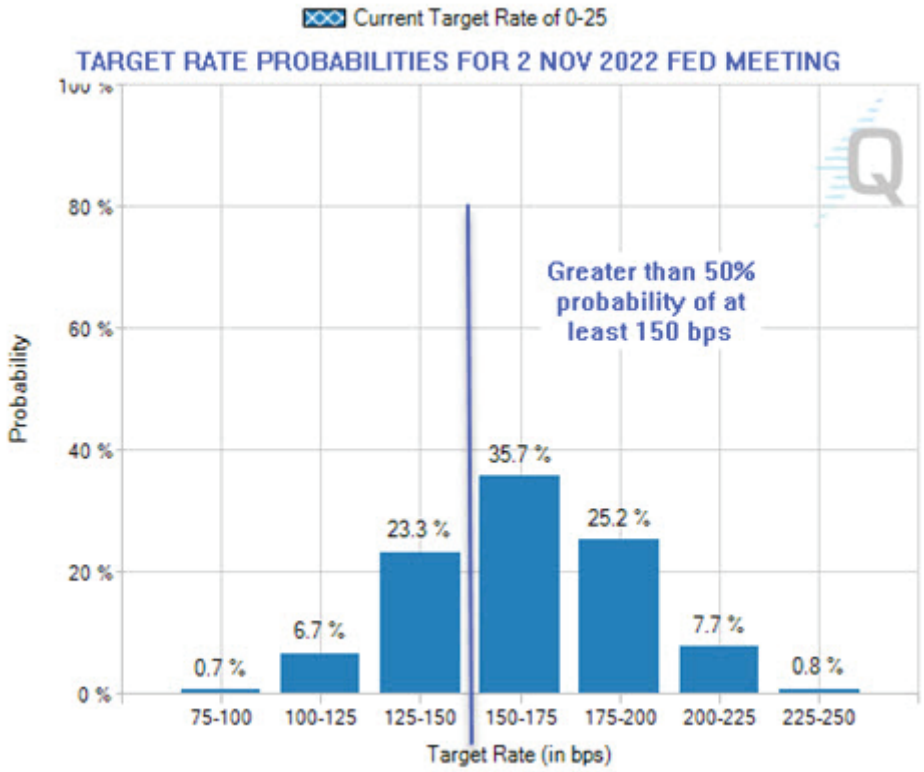
In the graph above, the blue line (2 Year Yield) leads the red line (fed funds rate). The Federal Reserve is consistently slow with its rate hikes as it tries to play it "safe." There is currently

a huge gap between the current federal funds rate, which is at 0-0.25bps and the 2 Year Yield which is currently trading at 1.6%.

In the 1990's the 2 Year Yield gap increased rapidly, outpacing the federal funds rate. However, this was a different situation than today. In the 1990's, the federal funds rate was above 3%, leaving some room to move lower if it had to. In addition, the Federal Reserve did not have a bloated balance sheet. The Federal Reserve was able to ratchet up its federal funds rate to 6%. They added 3% in quick order. Good luck this year with the Federal Reserve raising its federal funds rate 3%. It's not going to happen.

The graph below (CME Group) illustrates the investor expectations probability distribution of the federal funds rate at the November 2 meeting. Using interest rate futures, the graph illustrates that there is more than a 50% probability of the Federal Reserve hiking its federal funds rate six times by the Federal Reserve meeting in November.

Currently, the two year yield is trading at approximately 1.6% and is lining up with investors expecting the federal funds rate to increase six times by November. The problem is that November is nine months away. The Federal Reserve is way behind the curve.



At this point, the Federal Reserve is praying that inflation will start to cool down, otherwise the gap between the federal funds rate and the "2 Year Yield" could get out of hand. It is fairly obvious to most investors that the Federal Reserve should have been taking action much earlier. You have to ask yourself, do we need the Federal Reserve, why not just use the yield on the 2 Year US Treasury note as the federal funds rate (sarcasm, but with a bit of truth). The Federal Reserve may not be able to raise rates 300 bps like it did in the 1990's, but the "2 Year Yield" is indicating that it has to start taking action and soon.