Rates Spark: Has Powell seen Friday's payrolls?

It's a fair question. And it's not unusual for the FOMC to get a pre-glean of data ahead of release. Chair Powell certainly exuded a certain confidence that rates had peaked, and his most pertinent scenario was one where a rate cut could occur should the labour market weaken in a material fashion, even if inflation were to continue to prove a tad sticky

Chair Powell was notably less hawkish than expected

The net dovish tint to Chair Powell's words allowed Treasury yields to ease below key levels (2yr below 5% and 10yr below 4.6%). While clearly more hawkish than he was last meeting (as he had to be, given the inflation readings), he interestingly outlined a scenario where the Fed could cut if the labour market weakened by enough, even where inflation remained a tad sticky. Difficult for bond yields not to view that as bullish, as the route to an eventual rate cut is less tasking than it was. Real rates lower and inflation expectations lower, in tandem with lower nominal rates.

Not huge moves, but a very clear net reaction, and one that makes sense. At least, this side of Friday's payrolls report – the question is has he seen it? The Fed can see a preview. Suggests it might just be weak; conspiracy theory-ish, but just maybe. We likely will need to see the colour of Friday's payrolls report before taking next moves. The ADP report did not point to material weakness, so the jury remains out on it.

The slowdown in Quantitative Tightening (QT) is a net loosening versus where we were

The interesting aspect of the FOMC outcome directed especially to bonds is the slash in the monthly roll-off of Treasuries from $60bn per month to $25bn. That represents a material $35bn of potential reinvestment back out the curve on the theory that the $60bn roll-off could have been maintained. By implication, any such re-investment would be done in a maturity weighted manner. In other words the sizes of reinvestment would be done in a manner that reflects outstanding issuance by maturity. We assume this is the case unless the Fed were to say something different. This is a net positive for bonds, and net neutral for the curve, albeit marginally in favour of the long end.

With respect to the MBS roll-off, there is no change in the official roll-off target (still $35bn). However, over the past year this has actually been running at around $16.5bn per month. The slower roll-off reflects slower underlying mortgage prepayments. By implication, it would not be inconceivable for the Fed to do in excess of $35bn per month should pre-payments accelerate in the future; for example when the Fed starts to cut rates (encouraging some more prepayment). The Fed has not been clear on how they would deal with a pre-payment spurt, but they have also not ruled out quicker roll-offs on MBS where possible (to help recover lost ground).

On the lower monthly numbers, the Fed will continue with QT right through 2024 and well into 2025.

> Bottom line though, we maintain our view that the decrease in roll-off is quite anticipatory. We continue to identify an excess of liquidity in the system of comfortably in excess of $750bn. Latest data show $500bn going back to the Fed on the reverse repo facility, which is the market posting liquidity back to the Fed. And bank reserves are still some $250bn above the $3tr market above which they are seen as ample. And Chair Powell was balanced, but net dovish relative to where he could have been. There is a series of data due Tuesday. Mostly second tier. Friday's payrolls report is key.

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