End of Quantitative Easing & Future Fed Funds Rate II

We last visited the Atlanta Fed Shadow Fed Funds Rate\(^1\) in January 2016, when we noted that, based on this measure, the Fed had already made increases in the Funds Rate equivalent to 300 basis points (3%) of “tightening”.

As we wrote in 2016, “Economists Jing Cynthia Wu and Fan Dora Xia from University of Chicago came up with a novel way to measure the impact from these stimulative measures during near zero interest rates. They created the “Shadow Fed Funds Rate” a measure of the underlying Fed Funds Rate.”

Today we note the Shadow Fed Funds Rate again (Figure 1). It suggests that the Fed has already reduced rates by 4.3%.

Figure 1

Fed Funds Target Rate and Atlanta Fed Shadow Funds Rate

Data are plotted Monthly to June 30, 2021

Source: Federal Reserve Bank of Atlanta, Federal Reserve, Bloomberg LP, Wright Investors' Service, Inc.

\(^1\) https://www.nber.org/system/files/working_papers/w22856/w22856.pdf
Perhaps of greater interest is the most recent update, which reflects a small reversal in the overall trend, which has been in place since late 2019.

We acknowledge that one data point does not make a trend. Nevertheless, the uptick is supportive of the larger debate at the Fed and in the bond market, namely: When will the Fed start to consider how and when it will tighten interest rates using more conventional means (such as changing bank reserve requirements, reducing and eventually eliminating open-market purchases of debt, and the outright increase in the Funds and Discount rates)?

The following table sets forth the Fed’s median expectations as of June 16, 2021, for the Funds Rate over the next three year-ends and “long run”. Also shown are market expectations based on Fed Funds futures as of July 13, 2021, and the median forecast of economists polled by Bloomberg on July 9, 2021:

<table>
<thead>
<tr>
<th>Pace of Policy Firming</th>
<th>2021</th>
<th>2022</th>
<th>2023</th>
<th>Long Run</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median</td>
<td>0.13%</td>
<td>0.13%</td>
<td>0.63%</td>
<td>2.50%</td>
</tr>
<tr>
<td>Fed Funds Futures</td>
<td>0.09%</td>
<td>0.29%</td>
<td>0.70%</td>
<td>1.12%*</td>
</tr>
<tr>
<td>Bloomberg Survey</td>
<td>0.25%</td>
<td>0.35%</td>
<td>0.85%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

*For settlement December 2026

Recently there has been a “pulling forward” of the timeframes the market and economists expect the Fed to begin raising rates. While the differences in end-of-period expected rates is not enormous, they show that the market is beginning to price in increases in the Funds Rate at an earlier time than the Fed is projecting.

Interestingly, while the market has been making these adjustments to the short end of the yield curve, longer-dated Treasurys have moved lower in yield, with the 10-year moving from 1.74% at the end of March 2021 to 1.35% as of this writing. The obvious narrative of this move is that expectations for future economic growth are beginning to slow down, perhaps gravitating back to levels seen in the years after the Great Financial Crisis and before the COVID-19 pandemic. It also suggests that the market views the recent spike in measures of inflation to be transitory in nature.

How fast the economy grows and how long or permanent the recent rise in inflation will be is yet unknown. However, taking a step back from this, the evidence suggests we will likely continue to experience low interest rates for an extended period.

If correct and using history as a guide, we believe this outlook implies that, in addition to a focus on quality and diversification, investment success may come from stocks over bonds, growth over value, large over small, and US versus International.

**July 14, 2021**

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