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Interest Rate Liftoff & Geopolitical Uncertainty — How It's All Impacting Fixed Income Markets

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Just when it felt as though the world was starting to get back to some semblance of normalcy with regards to the battle against COVID, the world took a spin for the surreal. The Federal Reserve had an eventful Q1 with the end of tapering, the first interest rate hike since late 2018, which marks the beginning of a new tightening cycle, and the potential augmentation of tightening through more aggressive balance sheet reduction on the near horizon.

Tragically, we have been witnesses to the first land war in central Europe since World War II as Russian forces invaded Ukraine. While the human toll on both sides cannot be ignored, the implications for the global financial markets and economy need to be considered as well. Ukraine has long been considered the breadbasket of Europe, and the potential delay or complete omission of the spring planting season will have far reaching ramifications on the rest of the world.

While most of the world is slowly opening up, rising COVID cases and a zero-tolerance policy in China will have significant ramifications on a fragile and slowly recovering global supply chain. Inflation, one of the victims of that supply chain congestion, continues to rear its ugly head as it has shed the mantle of transitory and appears to be here for a while.

In Q1, the Fed met on two occasions, with the second meeting more relevant than the first. While the acceleration of tapering was announced at the January meeting, setting up a completion date in March, which is well ahead of the previous end target month of June, the Fed meeting in March was key. It was at the March 16 meeting that the Fed took the first step in the next tightening cycle, increasing the fed funds rate by 25 basis points (bps) to a range of 0.25% to 0.50%. This somewhat standard rate hike did not come without drama as members of the Fed referenced the potential for a 50 bps rate hike at the March meeting, citing the significant and ongoing rise of inflation. To paraphrase Jim Nance's classic reference to the upcoming Masters Tournament, this could be a tightening cycle "unlike any other."

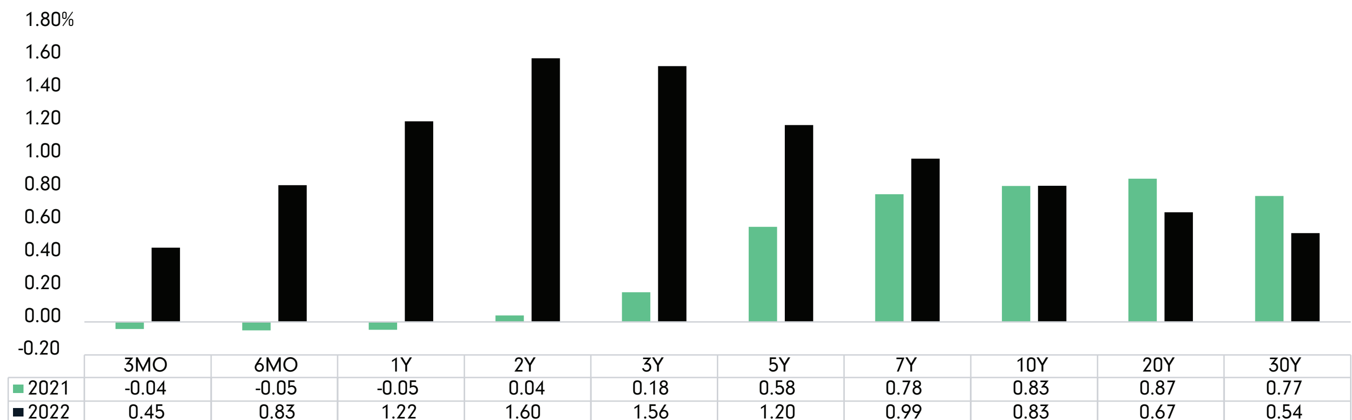
There has been a tightening cycle during which the Fed was passively reducing its balance sheet, but there has not been a cycle where the Fed was aggressively reducing its balance sheet. Recall that during the tightening cycle that ran from 2015-2018, when the Fed raised the fed funds rate nine times (25 bps each time), the Fed began balance sheet normalization in October 2017, allowing $6 billion in Treasuries and $4 billion in mortgage-backed securities (MBS) to mature each month and not be replaced. The caps would increase each quarter until they reached $30 billion in Treasuries and $20 billion in MBS, per month. Quantitative tightening, as the process came to be called, continued until March 2019 when the Fed announced that the monthly cap for Treasuries would be reduced from $30 billion per month to $15 billion per month, thus slowing the reduction of the Fed's balance sheet.

As we embark on the latest tightening cycle, various members of the Fed are pushing for more aggressive front end rate movements as well as an active approach to balance sheet normalization. Though the past two cycles have focused on 25 bps increases per meeting (2015-2018 had nine 25 bps hikes, 2004-2006 had 17 hikes of 25 bps each), one only needs to look at the 1994-1995 cycle for precedent on hikes above and beyond 25 bps. During that cycle, which saw the fed funds rate climb from 3.00% to 6.00%, the Fed used three 25 bps rate hikes in the beginning, followed by two 50 bps moves, a 75 bps increase in November 1994 and a final increase of 50 bps. So, with a potentially more aggressive Fed on the rates side and the balance sheet side, could we see something that is a mix between the 1994 cycle and the 2004 cycle? Truly, a cycle unlike any other.

Between the geopolitical uncertainty and the outlook for the Fed's potential actions, Treasury yields were on a consistent path higher throughout the quarter. Whereas the movement in Q1 2021 was focused on the longer end of the curve as the mix of accelerated vaccine distribution, expectations for an end to quarantines, two stimulus packages and a re-opening of the national economy caused markets to rotate in anticipation of a juggernaut economy. That is evidenced by the strong move higher in yields on the longer end of the curve in Q1 2021, as illustrated in Exhibit 1. The shorter end of the curve remained anchored as the Fed remained steadfast in its goal of maintaining lower rates on the short end of the curve. All of that began to change in Q4 2021 and carried over into Q1 2022.

During Q1 2022, the longer end of the curve moved in a similar fashion to Q1 2021, with the 10-year Treasury matching the increase almost exactly. The major shift was on the shorter end of the curve as the Fed stepped up rhetoric around rate hikes and the market began to anticipate the impending tightening cycle. The 160 bps move higher in the 2-year Treasury represents the third largest quarterly move since Q2 1984 (167 bps) and Q3 1981 (203 bps). The 160 bps represents an increase of 219% during the quarter, by far the highest quarterly percentage increase ever. The meteoric rise of the yield on the 2-year Treasury reflects the market expectations for an additional 2.25% in FOMC rate hikes by year end, delivered potentially through some combination of 25 bps and 50 bps hikes (or maybe something else?).

Exhibit 1 — Yield Change During First Three Months of the Year



	3MO	6MO	1Y	2Y	3Y	5Y	7Y	10Y	20Y	30Y
2021	-0.04	-0.05	-0.05	0.04	0.18	0.58	0.78	0.83	0.87	0.77
2022	0.45	0.83	1.22	1.60	1.56	1.20	0.99	0.83	0.67	0.54

Source: Bloomberg.

For the first time since World War II, central Europe has been engulfed in conflict as Russian forces invaded Ukraine in late February. The reactions were nearly instant—condemnations from across the globe, a slew of economic sanctions levied upon the Russian economy and various oligarchs, and energy prices soaring on supply uncertainty. Treasury yields jumped lower with a traditional flight to quality reaction from the market, but it was short lived as the markets and the world quickly adjusted to an ongoing conflict in Europe.

Not only was the impact felt in the energy markets with soaring oil prices, commodities such as corn, soybeans, wheat, barley and vegetable oils moved sharply higher. Ukraine accounts for roughly 10% of global wheat exports, 15% of global corn exports, 15% of global barley exports and 50% of global sunflower oil exports—and there is a near certainty that the spring planting season may not end up taking place. Continuing increases in these key inputs to food prices will add to the angst of higher energy prices and could result in inflation pushing even higher than the year-over-year 7.9% reported in February. Add in a surging spread of bird flu, resulting in the destruction of nearly 15 million egg producing chickens, and the usual trip to the grocery store could become more and more expensive.

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