DIAMOND HILL

INVESTED IN THE LONG RUN

Jackson Hole — No Nonsense, To the Point

Aug 2022

Powell brings the pain at Jackson Hole (time of speech, no nonsense and to the point), and the markets feel it along with an examination of the lack of progress in quantitative tightening (QT) and upcoming acceleration.

Jackson Hole Economic Symposium

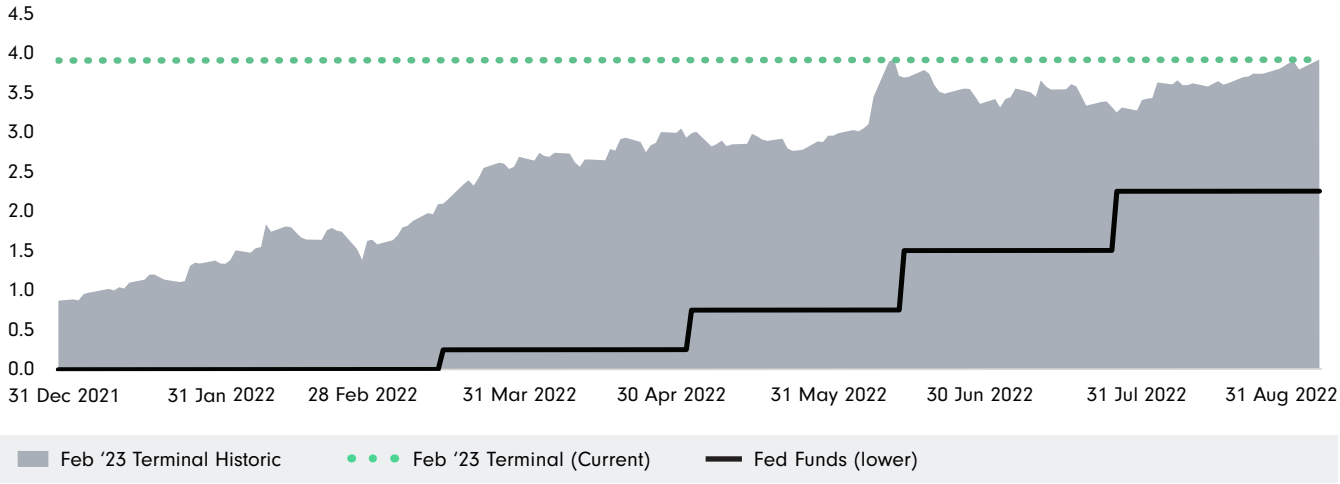
In roughly eight minutes of speaking time, Federal Reserve Chair Jerome Powell was able to reaffirm the Fed's commitment to battling inflation, spook risk markets and pivot expectations for a 50-basis point (bps) or 75-bps rate hike at the September meeting towards incoming economic data. While referencing the more recent drop in inflation (from 9.1% in June to a still white-hot 8.5% in July), Powell clearly stated that, while welcome, the drop was not enough to waylay the Fed's plans for rate hikes.

With the labor market appearing to maintain its strength (3.7% unemployment for August with 315k jobs added), the Fed is laser focused on battling inflation and the effort to reach a more normalized level. Powell didn't mince words when it came to the potential economic fallout of a hawkish Fed, "While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses. These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain."

The result of his speech? Heading into the meeting, Fed futures were pricing in a near 50% chance of a 75-bps increase. A week and a half after his speech? As of September 6, an 82% chance of a 75-bps increase is expected at the September 21 meeting. The S&P 500 has lost -6.87% since the Jackson Hole Symposium through September 6 and the 2-year and 10-year Treasury bellwether yields are up 10.6 bps and 30.8 bps, respectively. Message received loud and clear.

Exhibit 1 illustrates the change in expectations for the Fed's terminal rate. The green dotted line represents the August month-end February 2023 Fed fund futures contract, indicating a terminal rate of about 3.91%, or roughly 150-175 bps higher than the current fed funds range (2.25% to 2.50%). The gray area indicates the historic shift higher in those same expectations as time progressed from the beginning of the year to the current month end. Notice the significant ramp up near the end of August, interrupted briefly in reaction to another strong payroll report, reflecting the market's reaction to Powell's commitment to battling inflation.

Exhibit 1 — Implied Terminal Rate (February 2023) (%)



Source: Federal Reserve Economic Data (FRED), Bloomberg.

Quantitative tightening set to ramp up significantly in September

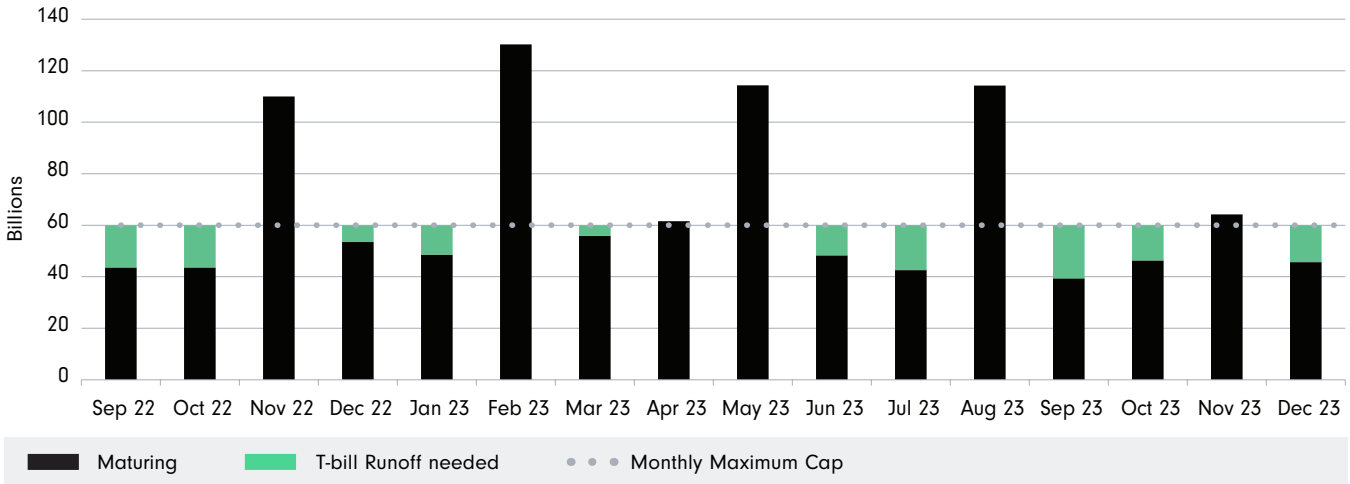
The Fed is not selling anything outright at this point in time; it is simply allowing maturing securities to roll off the balance sheet without replacing them. The initial caps or amounts of maturing securities on the Fed balance sheet that would be permitted to roll off without being replaced were $30 billion in US Treasuries and $17.5 billion in agency mortgage-backed securities starting on June 1. As of September 1, those levels have doubled to $60 billion and $35 billion, respectively. For the Treasury portion, the process is rather straight forward. Here is an outline of the next three months:

September – One Treasury security matures on September 15 followed by three maturities on September 30, totaling $43 billion. With caps increasing to $60 million for Treasury securities at the beginning of September, it means that the Fed will need to allow $17 billion in Treasury bills to run off as well.

October – Similar pattern to September with one Treasury maturity on October 15 and an additional three maturities on October 30, totaling $43 billion, necessitating the need to allow $17 billion in Treasury bills to run off.

November – Two Treasury maturities on both November 15 and November 30, totaling nearly $110 billion, meaning that $60 billion will roll off and the remaining $50 billion will be reinvested.

Exhibit 2 — Treasury Quantitative Tightening Projections ($)



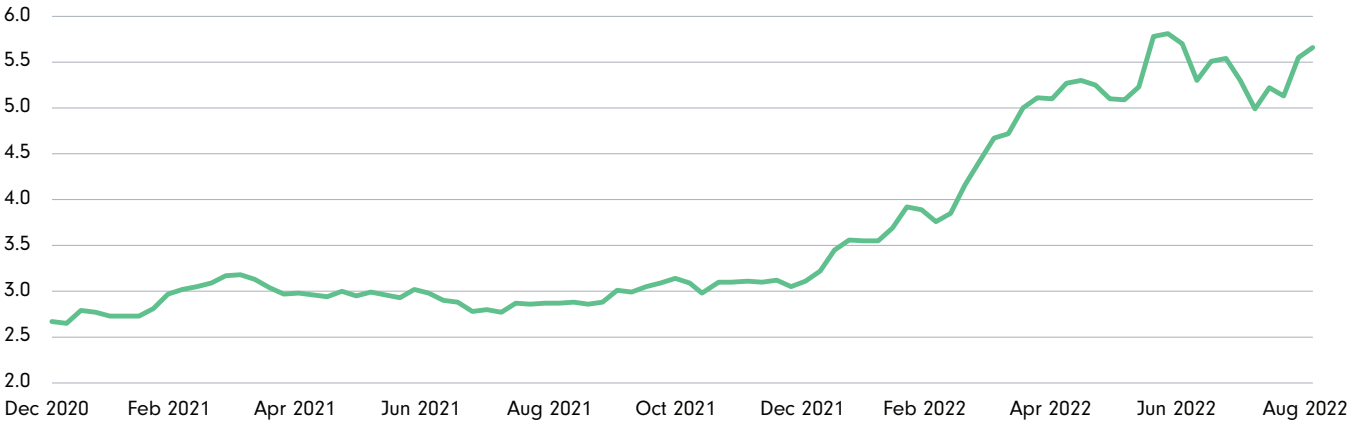
Source: Federal Reserve.

As outlined above, the Treasury process is somewhat clean, but the mortgage process will become more and more complicated. As rates have continued to climb throughout the year, the pace of mortgage refinancing or pre-payments has slowed considerably, reducing the amount of money flowing into the Fed from these assets each month.

Since QT 2.0 began on June 1, the 30-year fixed-rate mortgage average, according to the Federal Reserve Economic Data (FRED) website has climbed from 5.09% to 5.66%, as of September 1 (Exhibit 3). Even more important than the short-term increase, the national average at the beginning of the year was 2.67%, less than half of its current rate.

By examining the mortgage holdings in the System Open Market Account (SOMA), we can see that most of the mortgages held by the Federal Reserve are historically low coupon mortgages. Specifically, 45% of the mortgage-backed securities (MBS) held by the Fed have coupons in the 1.50% to 2.00% range and nearly 48% in the 2.50% to 3.50% range. The remaining 7% of mortgages held by the Fed have coupons ranging from 4.00% to 6.00%, with most of this group having a 4.00% coupon.

Exhibit 3 — 30Y Fixed Rate Mortgage Average (%)



Source: Federal Reserve Economic Data (FRED).

With the increase in mortgage rates throughout the country, prepayments and refinancing have been slowing down. This deceleration of payments could put the Federal Reserve in the position to either sell mortgages to maintain its pre-determined caps of $35 billion per month or be satisfied with whatever prepayments are received, even if those payments fail to reach the pre-ordained cap.

We can only speculate how the continuing unwind of the mortgage portfolio will progress, but we can examine the Fed's balance sheet to see the impact of the quantitative tightening that has been in place since June 1. Utilizing data directly from the FRED website, we can see that while the Treasury holdings in SOMA have declined by roughly $70.1 billion, the agency MBS holdings have *increased* by $18.5 billion.

During quantitative easing — and to a much lesser extent during the taper and to a minuscule extent now — the Fed tries to keep the balance of MBS from shrinking too fast by buying MBS in the "To Be Announced" (TBA) market. But purchases in the TBA market take one to three months to settle. The Fed books its trades after they settle. So, the purchases included in any balance sheet reports were made one to three months earlier. This delay is why it takes months for MBS balances to reflect the Fed's current purchases. The purchases we see show up on the balance sheet in June were made somewhere around March and April. As we move into September, we should see this lag effect start to wane and the reduction in the MBS portion of the balance sheet commence in full.

S&P 500 Index measures the performance of 500 large companies in the US. The index is unmanaged, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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