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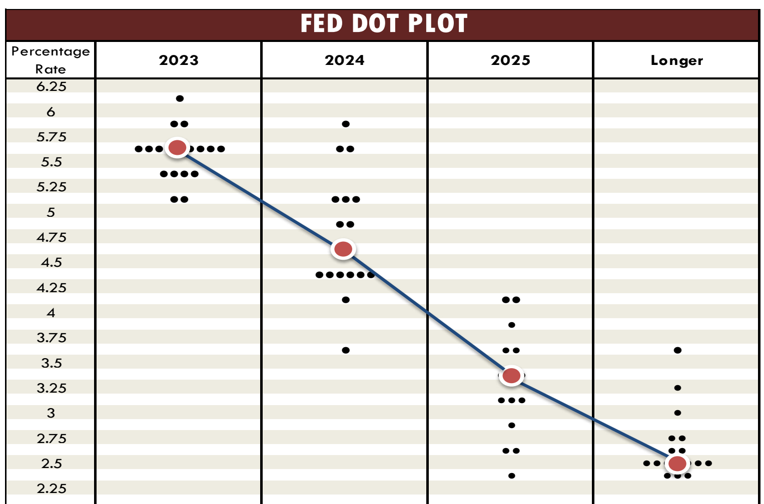
The Case of the Bond Market's "Other Terminal Rate"

Close watchers of the U.S. Treasury market are fluent in the Fed "dots", that is, the policy rate projections that each Fed Governor and each Fed Bank President puts on paper four times a year. These "Dots" help investors understand the Fed's thinking and were originally devised to do exactly that: to inform investors during the 2010-2020 period that the Fed planned to keep interest rates lower for a longer period of time. With that quasi-assurance, investors bid down the yields of longer-term bonds and, so went the thinking, stimulated interest-sensitive sectors such as housing and automobiles.



Source: *Summary of Economic Projections, June 2023*

In 2022-2023, the low interest rate policy is gone, but the dots remain. Every 90 days, the individual Fed policy makers write down their estimates for the path of interest rates for 2023-2024-2025 and a "longer-term" dot with an unspecified date as well. And a critical focus within the 2023-2025 horizon has been, "What is the terminal rate?", i.e. the highest rate that the Fed will reach in raising interest rates before it stops and even begins cutting interest rates. Debating this "terminal rate" is certainly a worthy exercise, and it has been productive for investors who, like ourselves, felt that interest rates needed to rise higher than previously expected in order to fight inflation.

However, we also confess that we have always been somewhat confused by the terminology, because we think that the true "terminal rate" would be that almost-never-mentioned dot, the longer-term policy rate in the Fed's projections. It's so forgotten that the potential duality and confusion of the wording never draws a mention. But let us skip the semantics exercise and go straight to the analysis:

The Fed's current long-term dot is and almost always has been at a policy rate of 2.5%, which translates clearly and explicitly into the Fed's hitting their 2.0% inflation and needing a "real" (or inflation-adjusted) interest rate of 0.5% on top of that in order to keep the economy and inflation stable and neither too hot nor too cold.

Our contention about this long-term dot is that investors, and probably the Fed itself, are far too complacent about the risk that that dot will need to shift and cause something of an earthquake. We understand the utility for the Fed in signaling its commitment to its 2.0% inflation target in this way, but what about the remaining piece of the puzzle --- i.e. the 0.5% premium at which interest rates can remain stable when the inflation-fighting mission is accomplished?

Here is where we at Northeast count ourselves as skeptical. It would require a long and necessarily complex debate to consider all sides of the argument, but we believe that we have learned in the last few years that 0.5% is not the right premium over inflation that is neither too hot nor too cold. We will dive deeper into the reasoning in a future piece, but for today we ask readers to allow us to assert that it is true.

If so, at some point the Fed will need to raise that longer-term dot. What would be the implications? As we said above, we think it is telling that the longer-term dot gets so little attention that there isn't even any confusion about which dot is properly called the "terminal rate"!

Our view is that the Fed will be forced collectively at some point (or Fed hawks will individually break ranks in order to make their point – remember, each member individually sets his own dot and we investors simplify by using median dots) to raise the longer-terminal dot. If and when the Fed raises that dot from 2.5% to 3.0% or even 3.5%. we believe it will be relatively straightforward but still necessary for the Fed to soothe investors that it is not raising its inflation target from 2.0%. But the second part of the puzzle, may cause a shock to markets.

After all, investors are now pricing in interest rate cuts on the basis of the Fed's succeeding in its inflation-reduction quest, yes, but also on the basis of being able to restore the policy rate to 2.5%, or 0.5% over inflation. If that is not going to happen, that is a big deal for bond pricing and the impact will swamp the more delicate debates being had today over whether, say, the Fed will start cutting two quarters out or three. The real action is where the policy rate will settle in the long-run, not these relatively minor debates.

So we at Northeast advise investors to focus on what is called the "terminal rate", yes, but also to stand ready for a change in the longer-term dot, a change that we think might very well be forth coming. And because such a change would require a rethink of not just what will happen in the next 24 months, but in the next 10 years, that would be impactful. Who knows, the longer-term dot might even start getting referred to as the "terminal rate".

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