# **Financial Conditions Monitor:** Tracking Market-Implied Growth, Inflation, and Fed Expectations

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*We systematically track the evolution of financial conditions and their underlying drivers. This monitor is a reflection of how we think macroeconomic and policy dynamics are affecting financial conditions and, by extension, our assessment of the economic growth outlook.*

## Takeaways

**Financial conditions have tightened since the February FOMC meeting largely in response to stronger growth and inflation information.** This certainly does not seem like a recessionary tightening of financial conditions. At an asset class level, Treasury yields, credit spreads, and the dollar are the source of tightening. In the context of hot PCE inflation, resilient US growth, and market-implied expectations of both, it is not a surprise for Fed policy rate expectations to also rise.

1. **We are still observing net tightening in most of the relevant barometers**, after a mini-reversal in December and January. As of now, this tightening seems to be in response to strong growth and inflation, rather than an original cause of weaker growth. Conditions are still much tighter than they were a year ago.

2. **125 basis points of net hikes have now been priced in over the next year.** While Fedspeak continues to posture hawkish, the repricing is more directly tied to strong US growth and PCE inflation data, and an upward rerating of the outlook. To the extent growth is proving resilient and inflation risks still elevated, the Fed inducing additional tightening is more justified within our framework.

3. **There are asymmetric risks of the Fed engaging in hawkish panic.** Residual seasonality is still showing its face in Q1, both in strong labor market data and strong inflation data. The risk now is that the Fed

reaccelerates back to 50bp hikes as a result. We think this would be an overreaction, but the Fed's hawkish posturing does raise a scenario which is not factored into financial conditions and the baseline growth outlook: **what if February CPI comes in hot and financial markets price in a 50 basis point hike at the March meeting (during the blackout period)?** We think/hope that the Fed would simply use the dot plot to signal marginal hawkishness, but there is a risk the Fed tries to opportunistically preserve all tightening that is already priced in. These issues will still lurk ahead of the May FOMC meeting.

## Financial Conditions Components

| Green = Easing<br>Red = Tightening | | Change Since | |
|---|---|---|---|
| | 3/3/23 | Feb FOMC | 1Yr Ago |
| S&P 500 (Price) | 4046 | -1.8% | -7.3% |
| Equity Risk Premium | 3.84% | -0.32% | -1.87% |
| VIX (20-day Average) | 20.3 | 0.5 | -6.7 |
| High Yield - Yield to Worst | 8.55% | 0.52% | 2.89% |
| CDX High Yield | 4.33% | 0.17% | 0.56% |
| High Yield Corp OAS | 3.97% | -0.22% | 0.39% |
| BBB Corp OAS | 1.47% | 0.02% | -0.02% |
| AAA Corp OAS | 0.56% | 0.00% | -0.17% |
| 30yr Fixed Mortgage | 7.12% | 0.76% | 2.91% |
| MOVE (20-day MA) | 113.1 | 1.0 | 17.2 |
| 10yr UST Yield | 3.95% | 0.54% | 2.11% |
| 2yr UST Yield | 4.86% | 0.75% | 3.33% |
| Trade-Weight $ | | 2.72% | 4.94% |

# Financial Conditions Components

| Fed Expectations Monitor | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Green = More Dovish Expectations, Red = More Hawkish Expectations | | | | | | | | | | | | | | | | |
| Current Fed Funds Rate | 4.57% | | | | | | | | | | | | | | | |
| Fed Funds Futures - Pricing By FOMC Meeting | | | | | | | | | | | | | | | | |
| FOMC Meeting | Mar '23 | May '23 | Jun '23 | Jul '23 | Sep '23 | Nov '23 | Dec '23 | Feb '24 | Mar '24 | May '24 | Jun '24 | Jul '24 | Sep '24 | Nov '24 | Dec '24 | Feb '25 |
| Implied Fed Funds Rate | 4.89% | 5.14% | 5.37% | 5.45% | 5.46% | 5.40% | 5.32% | 5.20% | 5.05% | 4.89% | 4.69% | 4.51% | 4.37% | 4.23% | 4.10% | 4.00% |
| Additional Basis Points of Hikes Priced | 32 | 57 | 80 | 88 | 89 | 83 | 75 | 63 | 48 | 32 | 12 | -7 | -21 | -35 | -48 | -57 |
| Changes YTD | 19 | 40 | 53 | 62 | 68 | 75 | 80 | 85 | 87 | 81 | 75 | 70 | 60 | 51 | 41 | 41 |
| Changes vs Feb FOMC | 26 | 48 | 61 | 72 | 81 | 92 | 103 | 114 | 121 | 126 | 128 | 128 | 123 | 113 | 113 | 113 |
| Probability of 25bps Hike at Given Meeting | 126% | 102% | 90% | 32% | 4% | -22% | -34% | -46% | -60% | -66% | -78% | -74% | -56% | -56% | -52% | -38% |
| Change YTD | 12% | 64% | 84% | 50% | 38% | 22% | 28% | 20% | 20% | 8% | -22% | -26% | -20% | -36% | -40% | -38% |
| Change vs Feb FOMC | 40% | 64% | 86% | 52% | 46% | 34% | 46% | 42% | 44% | 30% | 18% | 8% | 0% | -18% | -40% | 0% |

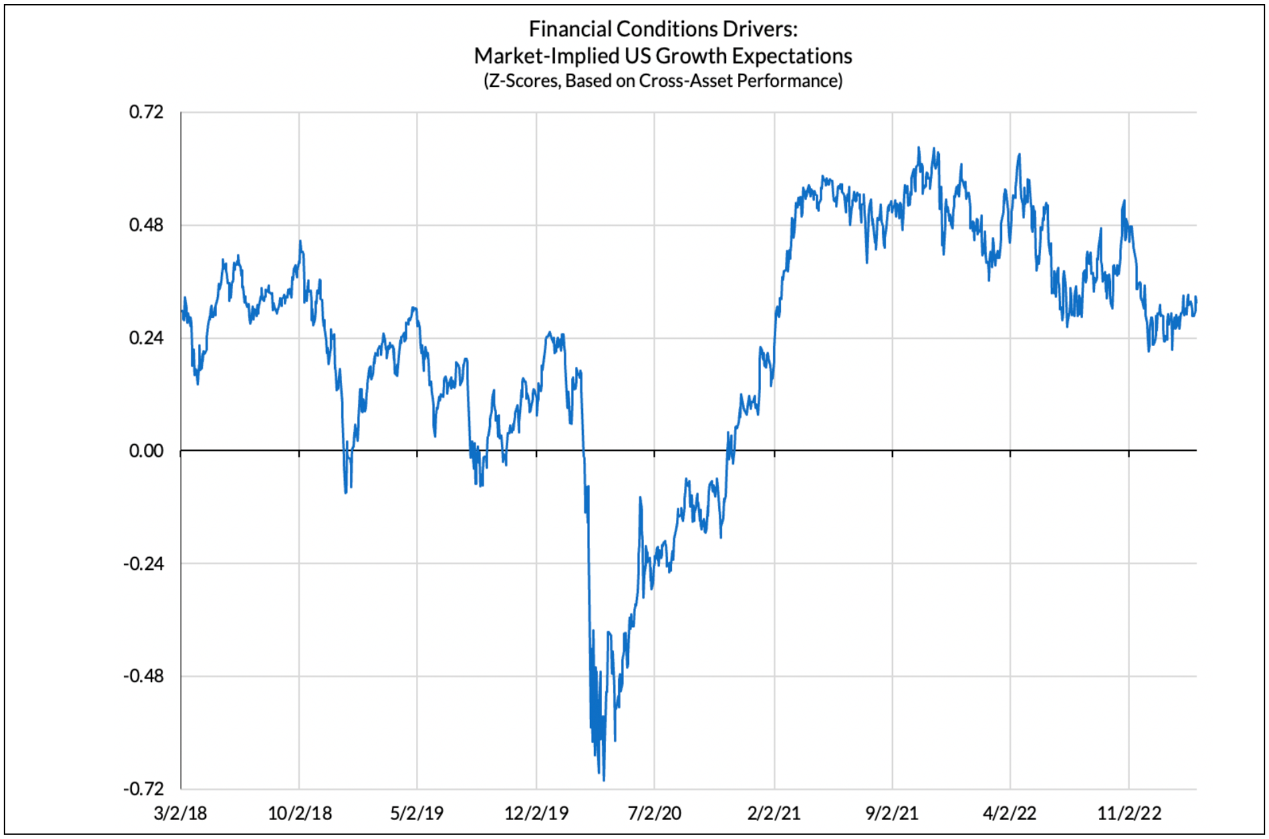
| US Treasury Yields | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Yields | 3M | 6M | 12M | 2Y | 3Y | 5Y | 10Y | 30Y |
| Current (%) | 4.84% | 5.11% | 5.00% | 4.86% | 4.60% | 4.25% | 3.95% | 3.88% |
| Change YTD (bps) | 49 | 35 | 33 | 49 | 44 | 35 | 21 | 4 |
| Change vs Feb FOMC (bps) | 20 | 35 | 36 | 75 | 81 | 73 | 54 | 31 |

| US Treasury Implied Forward Yields | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Yields | 3M | 3M3M | 6M6M | 1Y1Y | 2Y1Y | 3Y2Y | 5Y5Y | 20Y10 |
| Current (%) | 4.84% | 5.38% | 4.88% | 4.72% | 4.07% | 4.01% | 3.66% | 3.84% |
| Change YTD (bps) | 49 | 22 | 30 | 65 | 36 | 29 | 7 | -5 |
| Change vs Feb FOMC (bps) | 20 | 49 | 38 | 114 | 92 | 68 | 34 | 20 |

| US Treasury Yield Curves | | | | | | |
|---|---|---|---|---|---|---|
| Yields Curves | 2s 3s | 2s 5s | 5s 10s | 10s 30s | 2s 10s | 5s 30s |
| Current | -26 | -61 | -29 | -8 | -90 | -37 |
| Change YTD (bps) | -4 | -13 | -14 | -18 | -27 | -31 |
| Change vs Feb FOMC (bps) | 6 | -2 | -20 | -23 | -22 | -42 |

## Market-Implied Growth Expectations

While we see financial conditions tightening tempering the growth outlook, it's worth being clear that financial conditions are themselves responding to a more upbeat growth outlook. Typically long-term interest rates do not move higher when a recessionary dynamic is firmly afoot.




## Market-Implied Inflation Expectations

Inflation expectations have moved firmly higher in the past month. As is typically the case, this is most apparent in pricing over the upcoming 12 months, which have repriced over 1.1% in the last 4 weeks. We suspect much of this is a recognition that the lags associated with rent and OER inflation will affect CPI longer than previously anticipated. Nevertheless, **this upward rerating of inflation expectations is also adding ~0.3% to expected CPI in 2024, 2025, and 2026 and about 0.4% above what would be consistent with 2% PCE.** While we are skeptical of most inflation expectations measures, we think market-implied expectations are the most compelling. More importantly, the Fed is surely paying attention.

| CPI Inflation Breakevens | | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1Y | 2Y | 3Y | 4Y | 5Y | 10Y | 30Y |
| **Current TIPS Breakeven** | | | | | **2.79%** | **2.52%** | **2.40%** |
| July 2014 Anchor | | | | | 2.06% | 2.24% | 2.35% |
| **Now v. July 2014** | | | | | **0.73%** | **0.27%** | **-0.05%** |
| Change YTD (bps) | | | | | 0.48% | 0.26% | 0.09% |
| Change vs Feb FOMC (bps) | | | | | 0.44% | 0.25% | 0.17% |
| **Current CPI Swaps** | **3.32%** | **3.02%** | **2.91%** | **2.86%** | **2.84%** | **2.72%** | **2.52%** |
| July 2014 2% Anchor | 2.08% | 2.19% | 2.24% | 2.27% | 2.33% | 2.60% | 2.79% |
| **Now v. July 2014** | 1.24% | 0.83% | 0.67% | 0.59% | 0.51% | 0.13% | -0.28% |
| Change YTD (bps) | 0.99% | 0.62% | 0.49% | 0.43% | 0.38% | 0.23% | 0.09% |
| Change vs Feb FOMC (bps) | 1.10% | 0.72% | 0.57% | 0.48% | 0.42% | 0.27% | 0.11% |

| | CPI Inflation Forwards | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1Y | 1Y 1Y | 2Y 1Y | 3Y 1Y | 4Y 1Y | 5Y 5Y | 20Y 10Y |
| **Current TIPS Breakeven** | | | | | | **2.24%** | **2.28%** |
| July 2014 Anchor | | | | | | 2.42% | 2.46% |
| **Now v. July 2014** | | | | | | **-0.18%** | **-0.18%** |
| Change YTD (bps) | | | | | | 0.04% | -0.08% |
| Change vs Feb FOMC (bps) | | | | | | 0.00% | 0.00% |
| **Current CPI Swaps** | **3.32%** | **2.71%** | **2.69%** | **2.72%** | **2.74%** | **2.61%** | **2.41%** |
| July 2014 2% Anchor | 2.08% | 2.29% | 2.33% | 2.37% | 2.58% | 2.86% | 2.89% |
| **Now v. July 2014** | **1.24%** | **0.42%** | **0.35%** | **0.35%** | **0.16%** | **-0.25%** | **-0.48%** |
| Change YTD (bps) | 0.99% | 0.24% | 0.23% | 0.27% | 0.17% | 0.07% | 0.02% |
| Change vs Feb FOMC (bps) | 1.10% | 0.34% | 0.26% | 0.23% | 0.18% | 0.12% | 0.04% |