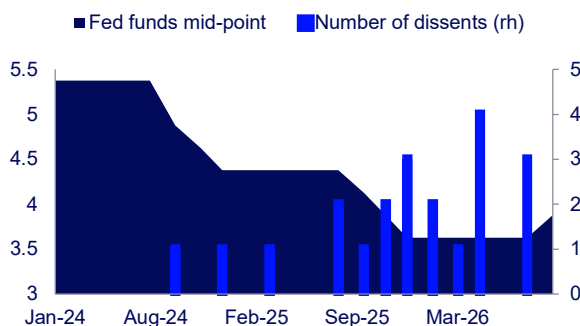


3Q:26 Fund Connect: still expecting higher rates

New Fed management under Kevin Warsh pushed against convention by raising rates by 25bps last month, while signaling that it expects to raise another 25bps before year end. The impetus for the hike has been driven by the Fed's goal to retake the inflation narrative after 5+ years above target. And while the economy does not seem to be overheating, it is also not showing signs of stress, prompting the FOMC's impatience on returning inflation to targets. Demand for capital is reaching acute levels, possibly influencing the risk management aspects of the hike. With many of those drivers in place, investors expect the Fed to hike again, at which point the Fed expects to remain on hold for the better part of next year. Investors, however, do not think this tightening cycle will end so soon, which will keep rates markets active going into the start of the year. And, even as short end liquidity remains ample, money fund managers are keeping their WAMs near the short end, a sign that additional rate hikes may be coming. Our investor behaviour has recently turned moderately negative, which may support additional demand for money fund assets, with MMFAUMs still near their all-time highs.

Sceptical hike: The Fed hiked rates for the first time in 2-years as its easing bias officially came to an end. And while market pricing clearly expected said hike, we would fancy that there was still a relatively sizable group of investors that were surprised by the move. The subsequent 7bps rise in 2-year yields, along with the 8bps flattening of the curve (2s30s), provides scope of the market surprise. Driving at least part of the market's reticence around rate hikes has been a litany of concerns/beliefs, including nascent signs of disinflation, historically weak levels of job creation, concentrated and narrow economic growth, and the view that new Fed management would not hike rates so close to the upcoming mid-terms. And while the Fed is signalling that further tightening remains its base case, rate volatility remains elevated, indicating continued scepticism over longer term pricing expectations. And while we do not think the Fed is done with their tightening cycle, the timing of the next hike remains in flux as we go into the penultimate FOMC meeting of the year. In this quarter's update, we will delve into the issues the Fed will likely debate as it decides the appropriate policy path for the next 12-18 months.

Figure 1: In agreement

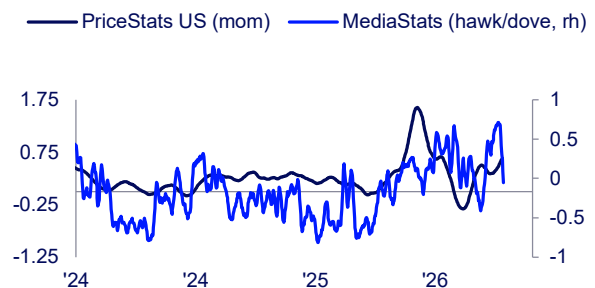


Source: State Street Markets, Bloomberg

Agreement: The September rate hike was accompanied by an unusual sense of consensus amongst the FOMC. Figure 1 shows the degree of policy dissent over the past few years. And while much of the 2024 disagreement was a protest vote from Miran calling for unreasonable rate cuts, there was

open outcry for tighter policy starting late last year. And while the regional bank presidents were the most vocal around hikes during FOMC meetings, there has been a general hawkish shift in overall Fed speak since the start of the year. Figure 2 shows that our media readings of hawkishness vs dovishness of Fed coverage started to notably, and sustainably, tick up near the start of the Iran war and remained net hawkish since then. Unsurprisingly, inflation readings also moved aggressively to the upside during this period, particularly headline readings, which include the impact of higher food and energy costs. And while we have not seen the same degree of pass through of higher prices into core readings of inflation, the tightening bias remains, with media still net hawkish and the dots calling for yet another hike before year end. We would note that there has been a recent compression in these expectations, particularly after the disappointing September jobs report, highlighting the classic jobs versus inflation friction that the FOMC must manage.

Figure 2: Pivoting hawkishly

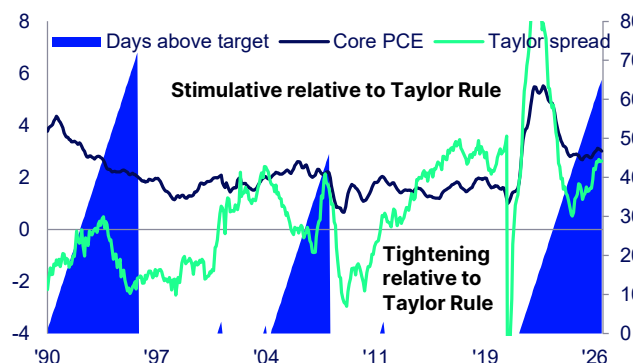


Source: State Street Markets, MKT Media Stats

New management: While the Fed operates under the dual mandate of full employment and price stability established by Congress, it generally has wide latitude on how to interpret and discharge its duties. At times, there is very little controversy, although there will always be some investor group that disagrees whenever the Fed hikes or cuts. Then there are times with high economic uncertainty, creating more 2-way policy risk that requires a clearer understanding

of the Fed's reaction function. Fed communication has been used to guide investors during these periods, although Warsh vehemently opposes forward guidance. Investors have therefore needed to adjust to this changing environment, taking cues from Fed speak and data.

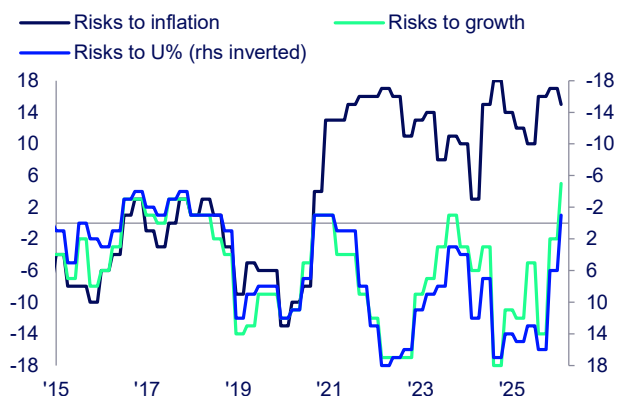
Figure 3: Above target...still



Source: State Street Markets, Bloomberg

On this front, the Chairman's voice still rings loudest, although Warsh has had a bit of a rough start during his first few FOMC meetings. He, however, appeared to catch his stride during Jackson Hole, making inflation the primary economic risk for the FOMC. Figure 3 highlights why the Fed is losing patience, with inflation exceeding targets for 65 months straight, while financial conditions still appear loose when applying a simple Taylor Rule measure for funds. Additionally, a diffusion index of FOMC members as part of the September SEP shows that risk to inflation remains acute, even as concerns over the labour market and growth have subsided. This is worth keeping in mind as expectations around the October and December FOMC meeting remains volatile.

Figure 4: Inflation remains priority #1

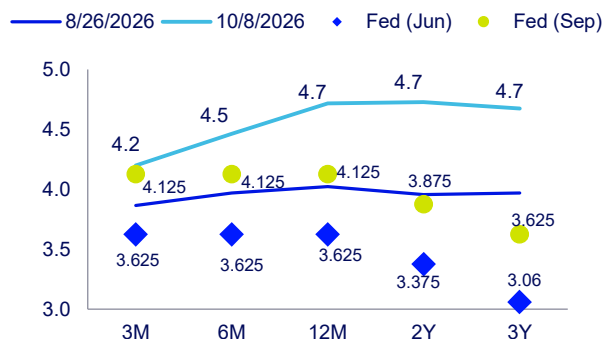


Source: State Street Markets, Bloomberg

Heavy lifting: One of the objections of Chair Warsh to providing forward guidance is that it dilutes the signals that can come from the bond market. Within this context, investors have a greater ability to influence financial conditions depending on their outlook on both fed funds and the shape of the yield curve. Figures 5 and 6 provide context that investors continue to expect the tightening cycle to

continue, with scope that rates may need to be notably higher than what Fed speak and the dots imply.

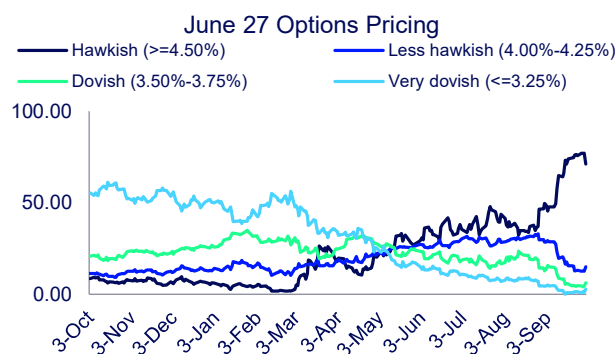
Figure 5: Upward and onward



Source: State Street Markets, Bloomberg

The upward bias in rates can be seen in changes to both Fed and market expectations over the summer. As Figure 5 shows, there was a general 50bps parallel shift in funds expectations from the FOMC across the forecast period. Higher rates are framed within short-term adjustments, as the Fed expects to step to the sidelines once tightening is completed this year. This is largely consistent with their prior views, except at a higher yield level, implying a desire to just moderately tighten financial conditions; essentially adjusting R^* to the current environment.

Figure 6: Still expecting more



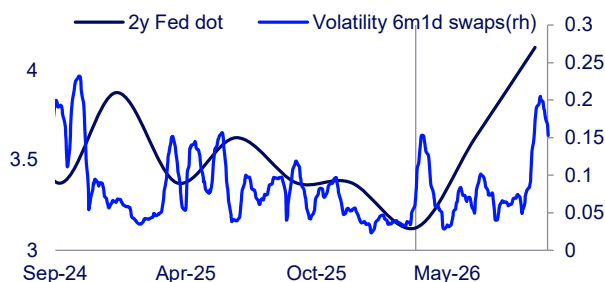
Source: State Street Markets, Atlanta Fed

Rate investors have similarly adjusted their expectations, adding an additional 50bps of tightening to their forecast horizon. This, however, lifts market expectations above the Fed dots, which ironically settled at investor expectations that existed before the September rate hike. Based on options pricing, the broad consensus is that rates need to get to at least 4.5% over the next year, well above the Fed's 4.125% median expectation for YE:27.

Error bands: We think there remains a wide range of opinions as to where policy rates need to settle during this economic cycle. And while the Fed has raised both the short-term path for rates and its longer-term neutral rate, the drivers for a higher R^* remains debatable. For sure, 5+ years of above target inflation warrant action, but we think the gentle upward path signaled by the dots is an indication that the Fed continues to expect that inflationary supply

shocks will prove short lived. Additionally, recent rates volatility in the face of disappointing economic data is yet another indication that policy is not on a predetermined path. The additional demand for capital, and possible systemic risk, is yet another intangible that investors need to remain cognizant of. There is no doubt that capital demand from the sovereign and corporate sectors is growing at a historically aggressive pace. Our analysis of U.S. corporate bond demand indicates 30%+ annual issuance trends this year, which simply adds onto last year's robust sales. The U.S. deficit situation is also well documented, but is now being joined by both developed and emerging market government demand. In our assessment, all these factors will keep upward pressure on both policy expectations and rates in general across the term structure, with market expectations remaining aggressive relative to Fed policy signals, unless there is a significant slowdown in economic activity.

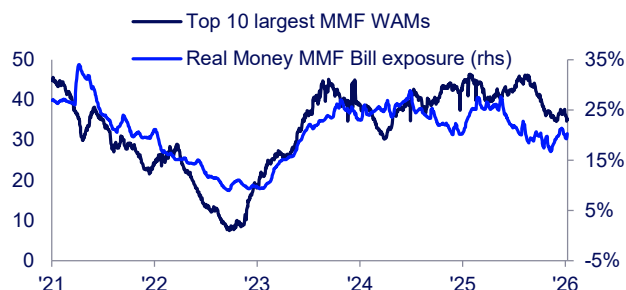
Figure 7: Vol remains high



Source: State Street Markets, Bloomberg

Remaining liquid: It remains the best of times for short-end investors, with overall AUM of \$7.9 trillion just marginally off their all-time highs. We suspect higher yields will continue to provide support for the short end and overall market liquidity. Figure 8 shows that the WAMs of the largest MMF managers have fallen by about 10 days over the summer, providing a relatively neutral maturity base with which to adjust to changing rate expectations. This change has occurred in conjunction with lower overall exposure to Treasury bills according to our proprietary data, which is consistent with funds lowering their WAMs. This is ultimately an unsustainable trend, however, with deficit funding likely to accelerate into year end, and Treasury's reluctance to increase coupon issuance. This should keep overall WAMs down in our view, as asset managers' position for both possible rate rises and cheaper treasury prices.

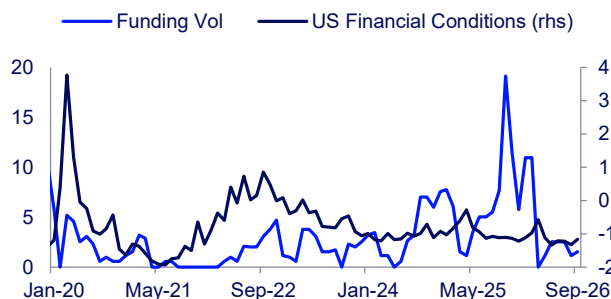
Figure 8: Keeping optionality



Source: State Street Markets, Bloomberg

Ample liquidity: For a second straight month, the Fed will not make any reserve management purchases, signaling ample bank reserve conditions that have existed since the summer. For sure, SOFR rates have remained below the administrated IORB rate since the start of the year, except for a few pockets of stress. The Fed is also now approaching RMP activity opportunistically as market stress emerges, so we may not get the typical signaling that had previously accompanied these liquidity events. Corporate tax payments and ramped up treasury issuance this fall may push the Fed to resume RMPs in the coming month, although that may prove to be for only a short period of time.

Figure 9: Ample reserves continue



Source: State Street Markets, Bloomberg

The TLDR. The September hike may have formally ended the Fed's easing bias, but it has not resolved the debate over where rates ultimately need to settle. The FOMC remains focused on re-establishing its inflation credibility, while resilient activity and unusually strong demand for capital provide little urgency to reverse course. Markets have taken that message a step further, pricing a higher terminal path than the Fed itself and keeping rate volatility elevated as investors weigh inflation against softer, albeit not outright weak, labor-market data. For money fund managers, the response has been to preserve optionality: WAMs remain short, liquidity is ample and AUM remains near record levels. Until inflation shows sustained signs of lasting moderation or economic activity deteriorates materially, the balance of risks continues to favor higher rates from here.

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