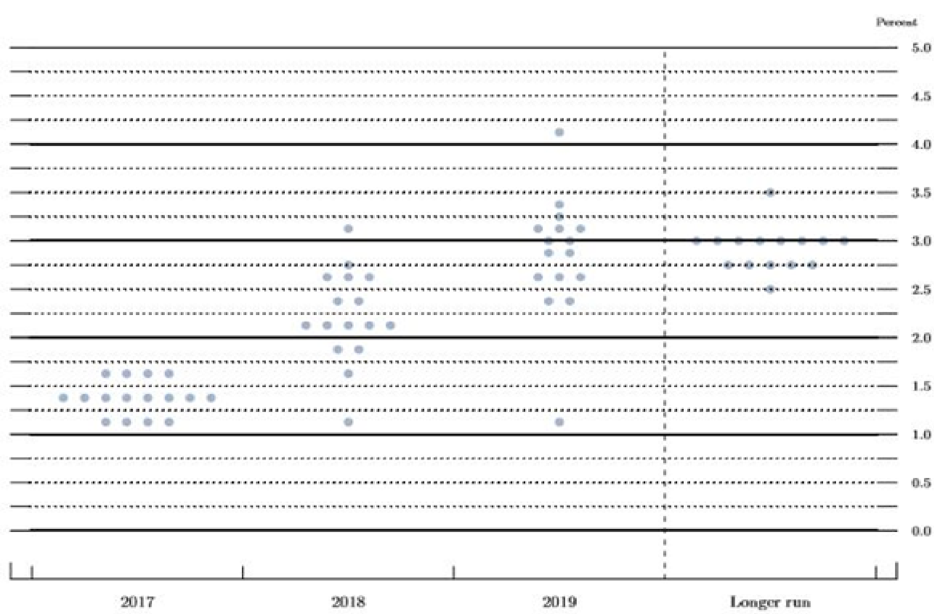
The Disconnect Between Interest Rates and Federal Reserve Projections

Who is Correct?

The current market environment presents a unique challenge for fixed income investors. The secular bull market has been one of the most protracted in history, with low interest rates extending from the 2008 financial crisis to the present. Equity markets have rallied to historically high levels. The economy has recovered gradually since the Great Recession providing justification for rising rates. However, yields have remained at historically low levels. Federal Open Market Committee (FOMC) policy, the greatest determinant of short-term interest rates, has become more transparent under Chairman Ben Bernanke and subsequently Chairwoman Janet Yellen. However, there is a current disconnect in the market between interest rate levels and FOMC projections. What is causing the dichotomy, and what are the implications for fixed income investors?

At the June FOMC meeting, the Fed raised the target rate by 0.25% to a range of 1.00% to 1.25%. The rate hike follows two 25 basis point increases in the past seven months (December 2016 and March 2017). The Committee also discussed plans to begin gradually unwinding the $4.5 trillion balance sheet later this year. The accompanying statement emphasized that policy remains accommodative, with the focus on rate normalization rather than tightening financial conditions. The FOMC also noted that economic activity has been rising moderately and job gains have been solid, but inflation has recently declined. The FOMC's forecast calls for inflation to rise gradually to the Fed's 2.00% target in the medium term, as labor conditions continue to tighten. The Fed's statement and projections were relatively hawkish, as they penciled in another quarter point rate hike this year, and three more quarter point hikes in each of the next two years, with a 3% rate in the longer run. Projections were essentially unchanged from the March meeting, although economic data overall and inflation in particular have been soft in the first quarter. As indicated below by the average of the Federal Reserve dot-plot diagram, projections place the Fed Funds rate at 1.40% at the end of 2017.

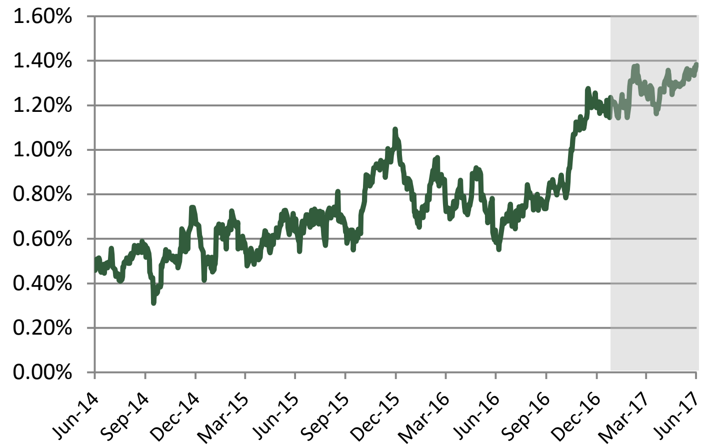
FOMC Projections – June 14, 2017



Source: Federal Reserve

Although the Fed has been very transparent in their communication, the market has not taken these projections to heart. After the FOMC press conference in June, the two-year treasury was trading at a yield of approximately 1.35%. The trading range has spanned between 1.16% and 1.38% over the last quarter. With a normal, upward sloping yield curve, investors would expect the two-year note to trade at a higher yield than the Fed's projected overnight rate of 1.40%. Even though the Fed has clearly and repeatedly telegraphed three rate hikes this year, the two-year treasury has not risen out of this narrow trading range. Additionally, unwinding the balance sheet is likely to nudge rates higher.

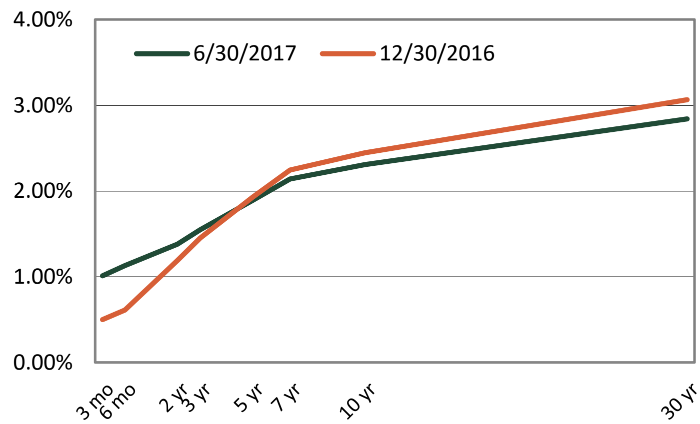
Historical Yields - 2 Year Treasury



Source: Bloomberg

After the June FOMC meeting, the yield curve continued to flatten, intensifying the trend over the last several months. A flattening yield curve is typical in a Fed tightening cycle; however, the protracted absolute low yield levels are not historically "normal". The five-year treasury declined to 1.72% and the 10-year treasury reached its lowest point since November 2016 at 2.16%. Lower yields on the longer end of the curve imply subdued inflation expectations in the longer run, counter to FOMC projections.

U.S. Treasury Curves



Source: Bloomberg

What are market participants thinking?

Fed funds futures are traded contracts that reflect market expectations for future FOMC rate actions. After the June meeting, fed funds futures were trading at a probability of approximately 42% for another rate hike in 2017. As of June 30, the market was pricing in a 16% chance of an additional rate hike at the September meeting, and the probability of another hike does not exceed 50% until December.

As reflected not only by fed funds futures but the aforementioned rate levels, the market does not seem to believe the Fed. Is the market's skepticism warranted? In both 2015 and 2016, the Fed's dot plot projected four rate hikes for the year. However, actions did not materialize, and in each December, we received a holiday present of a 25 basis point rate hike, which was "one and done" for the year.

Current Implied Probabilities

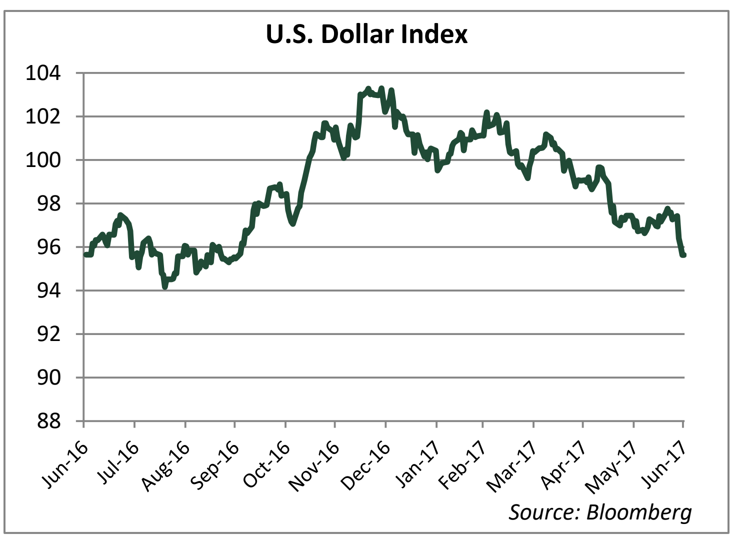
Meeting	Possibility of Hike
7/26/2017	0.0%
9/20/2017	16.0%
11/1/2017	16.7%
12/13/2017	51.6%
1/31/2018	52.5%
3/31/2018	67.8%

Source: Bloomberg, June 30, 2017

What drives the Fed's decisions?

There are numerous factors that comprise the Fed's decision making process. Some of the most important data includes the following:

- ***Employment*** The Fed has a dual mandate to promote maximum employment and stable prices. Employment growth has strengthened over the last several years, with a six-month trend of approximately 160,000 jobs per month being created and 4.3% unemployment, the lowest rate since 2001. Additionally, the unemployment rate for college graduates has fallen to 2.5%, creating a shortage of skilled workers. Although job growth has slowed in the first quarter, conditions are approaching full employment. However, the labor participation rate remains stubbornly low and wage growth has yet to materialize. The Fed's latest projections reflect downward revisions to the unemployment rate to 4.3% in 2017 and 4.2% in 2018 and 2019.
- ***Inflation*** The Fed's preferred gauge, the Personal Consumption Expenditures (PCE) index declined in April to 1.5% annualized growth after stripping out volatile food and energy components. Oil prices are captured in the PCE headline number, which fell to 1.7% annualized growth. The FOMC statement indicated transitory factors, such as one-time price declines in prescription drugs and mobile phone charges. The Fed lowered its Core PCE inflation projection to 1.6% growth for 2017, but expects to reach its 2.00% threshold in late 2018 as the labor market continues to tighten and wages gradually pick up.
- ***GDP*** Overall economic growth as measured by gross domestic product is projected by the Fed to reach 2.2% for this year, 2.1% in 2018, and 1.9% in 2019. This overall picture reflects consumer spending, business investment, government spending, and net imports and exports. Moderate economic growth is expected to continue for several years. Achieving these projections assumes improvement from first quarter growth of only 1.2%, but GDP data can be volatile from quarter to quarter.
- ***Global Factors*** In addition to the key components of domestic economic growth, the Fed pays close attention to global factors that affect our economy and financial markets. The dollar has strengthened over the last year, which can dampen our exports and GDP growth. However, the dollar has moderated in 2017 as other world economies and currencies have strengthened, and fiscal stimulus from the Trump administration has yet to materialize.



Additionally, over the last few years, other key central banks around the globe have pursued divergent policies from the FOMC. Both the European Central Bank and the Bank of Japan implemented accommodative policies to help fuel economic growth at around the same time the FOMC began scaling back accommodation. These policies resulted in negative rates abroad. Relatively higher rates in the U.S. have attracted global investment and have helped to cap longer term rates in the U.S. However, recent improvements in these economies have resulted in central bank policies and interest rates beginning to converge again. We have seen increases in German and Japanese benchmark interest rates and flatter sovereign yield curves.

The Bottom Line for Fixed Income Investors

Despite strengthening economic conditions, risks to growth persist, and the market remains skeptical of the Fed's projections and future actions. With so much uncertainty, what is an investor to do? Will interest rates inevitably rise?

The arguments for rising rates can be supported by several factors. On a macro level, the U.S. economy is relatively strong. The Fed seems inclined to gradually scale back accommodation and prevent the economy from overheating. We are seeing higher benchmark interest rates globally. The labor market is robust, and a shortage of skilled workers may lead to wage inflation. Lastly, the impact of fiscal spending is unknown at this point, but may result in more debt issuance If and when it does materialize.

On the other hand, arguments against rising rates can be supported as well. The developed market global growth outlook, as well as demographic trends in both the US and overseas, support interest rates remaining low by historical standards. Rising rates have been anticipated and even feared by the market for years now, but interest rates inside of five years continue to trade at a yield level below the targeted inflation rate. Reasons unrelated to the economy and monetary policy have fueled a flight to quality and demand for treasuries, such as political turmoil, China's slowdown, plunging oil prices, Brexit, and terrorism which have kept rates low. Are we in for more of the same? We can always expect the market to behave unpredictably, but how do we protect our investments?

Chandler's Final Thoughts

To manage effectively in an uncertain environment, begin by putting away the crystal ball. History demonstrates that no one can effectively predict the direction, magnitude, and timing of interest rate movements consistently. It also helps to "stay out of the weeds" and watch for macro trends in the data and how the market reacts to data releases. Most importantly, irrespective of your interest rate outlook, stay disciplined and avoid significant inconsistencies with your portfolio's risk tolerance and investment strategy. Take advantage of market dislocations and movements, but resist the temptation to dramatically shift portfolio duration or overall investment strategy with individual data points and one-off market moves. With a disciplined investment strategy, you are likely to achieve your investment objectives over an investment cycle.

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Questions?

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