LPL RESEARCH

BOND MARKET PERSPECTIVES

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THE FED'S POLICY CONUNDRUM

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

The Federal Reserve (Fed) left interest rates unchanged following last week's meeting, but markets expect it to raise rates two additional times this year.

While the macroeconomic backdrop is solid, the Fed must contend with crosswinds from trade rifts, inflation, currencies, and the yield curve when deciding on future monetary policy.

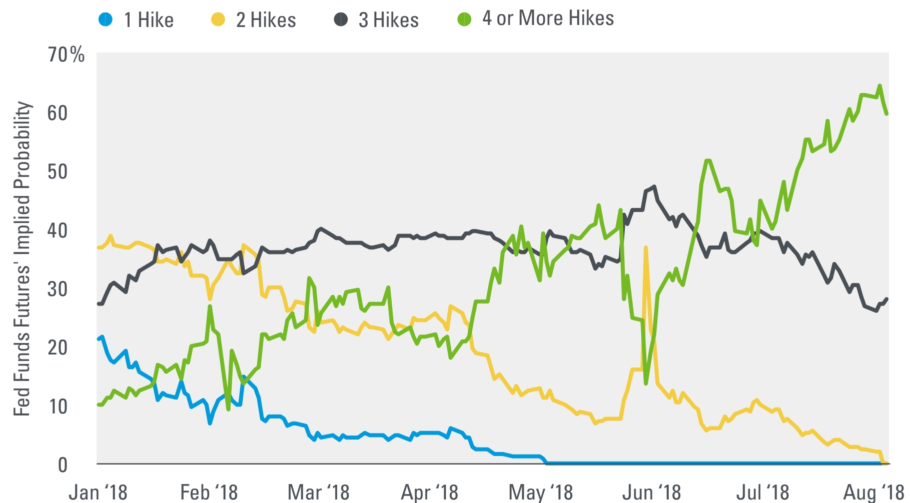
The Fed must also manage unwinding its balance sheet, a program scheduled to peak in October, with its gradual approach to increasing rates.

The Fed announced last Wednesday that it would keep interest rates unchanged, a decision that markets largely expected. In its statement, the Fed upgraded its view of the economy to growing at a "strong" rate for the first time since 2006, a view encapsulated by last quarter's strongest gross domestic product (GDP) growth since 2014. Fiscal stimulus has fueled strong business, consumer, and government spending, and the job market has continued to tighten, with the unemployment rate sitting at its lowest point of the expansion.

ECONOMIC GROWTH SUPPORTS HIGHER RATES

In a vacuum, the macroeconomic backdrop supports a gradual approach to raising rates, and market sentiment indicates four rate hikes this year is almost a foregone conclusion. Fed funds futures are pricing in about a 60% chance of two additional rate hikes by the end of 2018 [Figure 1].

1 FEDERAL RESERVE (FED) FUND FUTURES FORECAST A 60% CHANCE OF AT LEAST FOUR 25-BASIS POINT RATE HIKES THIS YEAR



Source: LPL Research, Bloomberg 08/03/18

Basis Points are a unit relating to interest rates that is equal to 1/100th of a percentage point. It is frequently but not exclusively used to express differences in interest rates of less than 1%.

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However, one of the biggest current debates among fixed-income investors is the future path of the Fed's monetary policy. Although the Fed has consistently repeated its intention to raise interest rates as the economy continues to strengthen, crosswinds from trade rifts, inflation, currencies, and the yield curve have muddled the case for future rate increases.

INFLATION EXPECTATIONS

As the economy strengthens, inflation has emerged at a slow and inconsistent rate, complicating the Fed's mandate of employing monetary policy to maximize employment and promote stable prices. Core personal consumption expenditures (PCE)—the Fed's preferred measure of inflation—rose 2.2% year over year in June, marking the fourth straight month that core PCE growth has reached the Fed's 2% target. However, wage growth is also a key economic indicator and driver of inflation, and it has lagged the Fed's expectations. Average hourly earnings grew 2.7% year over year in June, far below the 4% growth target the Fed has aimed for historically. While core PCE alone supports the argument for hiking rates, the Fed has begun to acknowledge that tepid wage growth is on its radar. Recently, the Fed has emphasized the "symmetric" nature of the core PCE target to reassure investors that it will consider the long-term trends of both price and wage growth. In July, Fed Chair Jerome Powell even said he was more concerned about low inflation than high inflation, contradicting the Fed's longstanding view that the U.S. economy is more prone to overheating.

The Fed is also contending with the flattest yield curve—in which longer-term interest rates fall relative to shorter-term rates—since before the financial crisis, reflecting in part fixed-income investors' hesitations around longer-term inflation expectations. Short-term yields have rallied swiftly, climbing along with the Fed's interest-rate increases (and expected future rate increases), while the 10-year Treasury yield has hovered around 3%. This is important because an inverted yield curve, where longer-term rates fall below shorter-term rates, has preceded each of the last nine recessions going back to 1955. Although we do not think this iteration of a flattening yield curve signals the end of an economic cycle, we understand why investors are anxious.

The Fed has begun to publicly acknowledge the flattening yield curve in the context of future monetary policy. St. Louis Fed President James Bullard (who does not vote on policy) said in July that "imminent yield curve inversion in the U.S. has become a real possibility" and stated that "it is unnecessary to push monetary policy normalization to such an extent that the yield curve inverts."

THINKING GLOBALLY

The Fed must also consider global economic stability when deciding on future monetary policy. The U.S. dollar has recently rallied to a 12-month high relative to its peers. Any future interest-rate increases could fuel more gains in the U.S. dollar as higher rates in the U.S. relative to other countries' government debt tend to attract foreign demand, and U.S. debt must be purchased with U.S. dollars. The result could be a destabilization of other currencies that could threaten global economic growth. These concerns are especially important for emerging markets, which are sitting on $4.5 trillion in dollar-denominated debt. To service this debt, emerging markets may have to dip into their reserves or raise interest rates to boost their local currencies. A higher U.S. dollar could also fuel rapid price growth that could eventually upend international economies reliant on U.S. imports.

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Trade tensions present a growing headwind for the Fed that could threaten future economic growth. Tariffs on $49 billion in goods have already been implemented, and tariffs on an additional $200 billion or more of Chinese goods have been discussed, including automobiles. Over time, tariffs are likely to drive prices up, and there is already anecdotal evidence that uncertainty around tariffs may be delaying additional business spending as companies await greater clarity.

BALANCE SHEET UNWIND

Over the past year, the Fed has begun efforts to unload about $4.2 trillion in U.S. Treasuries and mortgage-backed securities (MBS) bought when it implemented its quantitative easing policy in 2008. This bond buying injected liquidity into the global financial system and boosted bond prices, weighing down yields for the past several years. The Fed began selling these assets at a pace of $10 billion per month in October 2017, and is expected to reach a peak pace of $50 billion per month in sales this coming October. The Fed must balance its gradual approach to raising rates with this unwind.

CONCLUSION

The Fed understands the need for flexibility given these crosswinds. In July, Powell emphasized that the best path of monetary policy "for now" is to continue gradually raising the federal funds rate. Investors saw "for now" as critical, as the phrase demonstrated the Fed's willingness to be flexible with future tightening. If the Fed takes this path, we expect yields to grind higher through the end of the year (led by short-term yields) with periodic bouts of volatility. In light of this, we believe fixed income continues to play an important role in a diversified portfolio. Within fixed income, we favor short-duration, high-quality bonds to provide income and liquidity, as well as a portfolio management tool during stock-market volatility. ■

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Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

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