

## Normalization

### Overview

As we said in our last update (“Have Patience,” 3/20/15), for most of the past 6 ½ years, the Federal Reserve has found it necessary to take extraordinary measures to counteract the economic damage caused by the 2008 Financial Crisis. Overnight rates have been held at zero, and the Fed’s balance sheet expanded by \$4.5 trillion.

In March, we noted that change was coming. The Fed began to “normalize” monetary policy late last year by halting QE purchases. Next, they removed “forward guidance” from the statement. The next step in the normalization process is to set the stage for the first hike in the overnight rate since May 2006. Wednesday’s statement did this, by strongly suggesting that the hike could occur at the September meeting if economic data remains at current levels.

*A rise in the overnight rate will result in rising earning power from corporate cash on the balance sheet. As a result, this continues to be a critical period for short term corporate cash investors.*

### Analysis and Portfolio Impacts

- Based on current levels of interest rates, the market expects the first Fed Funds Rate hike to occur later this year, and the pace of rate increases to be gradual over time.
- However a discrepancy exists between the Fed Governors’ rate expectations and market expectations of those same rates. The Governors expect that Fed Funds will be at 0.625% on 12/31/15 and 1.625% on 12/31/16; the market, in the form of the forward curve, is predicting Fed Funds at 0.32% on 12/31/15 and 1.08% on 12/31/16.
- The Spread between the One and Two Year Treasury has moved steadily higher over the past few years. This is an indication that the market is beginning to price in the first Fed Fund Rate increase. We are expecting a September “liftoff.”

### One Year—Two Year Spreads



Source: Bloomberg

Richard Saperstein  
+1 917-286-2770  
rsaperstein@treasurypartners.com

Jerry Klein  
+1 917-286-2790  
jklein@treasurypartners.com

Brendan Jones  
+1 917-286-2772  
bjones@treasurypartners.com

[www.treasurypartners.com](http://www.treasurypartners.com)

- Conversely, the Spread between the Two Year and the Three Year Treasury has drifted lower over the past year, indicating that the market is expecting the slow, gradual pace of tightening that the Fed has been communicating.

#### Two Year – Three Year Spreads



Source: Bloomberg

- There is a risk that, with the two year at 64bps and the three year at 98bps, the market is not pricing in the risk that the Fed is forced to become more hawkish. The Fed has set an extremely low bar with their expectations for both the performance of the economy and the pace of the Fed Funds Rate increases. The risk may now be that unemployment and inflation move back to normal levels faster than their expectations, forcing them to react in a way that surprises the market, pushing the Three Year yield and the 2s/3s spread higher.

#### Strategy

Short Term Rates will continue to be volatile as the Fed approaches “liftoff”. Fed action is not fully priced into the front end of the yield curve.

For clients with existing portfolios, we will continue to reinvest with laddered structures, taking advantage of market peaks.

For corporate investors with new cash to invest, we plan to initiate a modified barbell structure with gradual reinvestment of the shorter maturities over the next three months.

Callable bonds have been attractive, and we continue to add these structures. Likewise, floating rate securities will benefit from a Fed tightening, and we have been selectively adding these where appropriate. Taxable Municipals have not been as attractive in the last few weeks, as they have not re-priced in line with the Corporate and Treasury markets; we do not expect this discrepancy to persist long-term, though, and will likely re-enter this market when it normalizes.

As always, please contact us at any time if you would like to discuss our strategy in greater detail.

**Disclosure**

Treasury Partners is a team of investment professionals registered with HighTower Securities, LLC, member FINRA, MSRB; and SIPC, and with HighTower Advisors, LLC, a registered investment advisor with the SEC. Securities are offered through HighTower Securities, LLC; advisory services are offered through HighTower Advisors, LLC.

This is not an offer to buy or sell securities. No investment process is free of risk, and there is no guarantee that the investment process or the investment opportunities referenced herein will be profitable. Investors may lose all of their investments. Past performance is not indicative of current or future performance and is not a guarantee. The investment opportunities referenced herein may not be suitable for all investors.

Treasury Partners has obtained all data and other information referenced herein from sources believed to be reliable. Treasury Partners and HighTower shall not in any way be liable for claims, and make no expressed or implied representations or warranties as to the accuracy or completeness of the data and other information, or for statements or errors contained in or omissions from the obtained data and information referenced herein.

The data and information are provided as of the date referenced. Such data and information are subject to change without notice.

This document was created for informational purposes only; the opinions expressed are solely those of Treasury Partners, and do not represent those of HighTower Advisors, LLC, or any of its affiliates.

**CONTACT US**

[info@treasurypartners.com](mailto:info@treasurypartners.com)  
+1 917-286-2770