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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

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- 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 repriced 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.

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