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Corporate Cash Alert

Keeping a Close Eye on Federal Reserve Policy

August 29, 2017

Executive Summary

- Since the election, 2 Year Treasuries have moved less than 0.10% higher despite 3 Fed hikes
- The market keeps discounting the probability of additional Fed hikes, pointing to low inflation and stagnant growth
- However, we believe the Fed will continue tightening via more hikes and balance sheet runoff
- Further employment gains could lead to wage inflation which is unpriced in today's markets

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Our corporate cash clients may have noticed that we are not aggressively extending maturities as we have in the past. In this Alert, we discuss the reasons behind our more cautious approach to buying longer-term bonds at current rates.

Market Discounting Fed Projections

Since December 2016 the Fed has tightened 3 times, bringing its benchmark Fed Funds rate from 0.25% to 1.00%. Moreover, various Fed governors have clearly signaled a continuing intent to tighten monetary policy going forward.

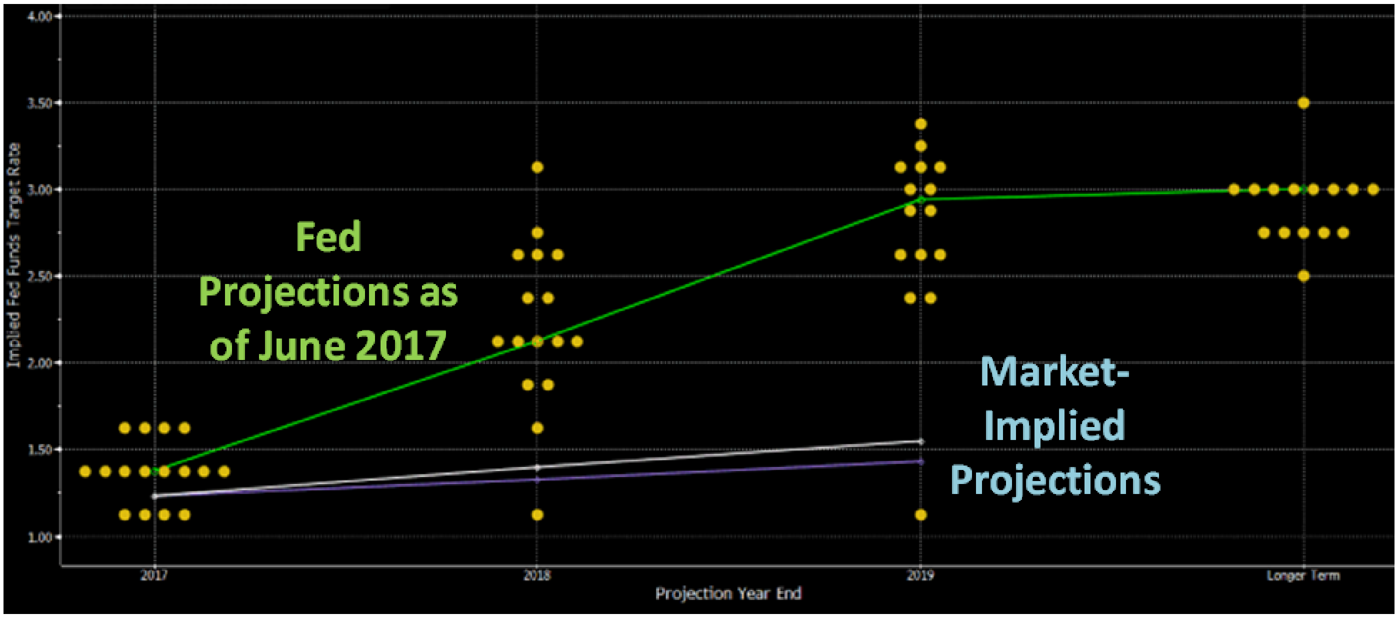
Normally, this sequence of events would result in short-end rates increasing. Interestingly, the size of the increases has been smaller than what was expected. For example, despite a total of 0.75% of rate hikes since December 2016, 1 year Treasury rates have only risen 0.25% while 2 year Treasury rates have risen by less than 0.10%. Moreover, 3 and 5 year Treasuries have actually *declined* by 0.05-0.25% during the same time period. The magnitude and direction of these market moves is inconsistent with the expectation of future Fed hikes.

1-5 Year Treasury Rates, 12/14/16 vs. 8/25/17

Source: Bloomberg

Taking a deeper dive into this paradox emphasizes this disconnect. According to the latest Fed projections, their median forecast for the pace of future rate increases is 1 additional hike in 2017 and 3 hikes in both 2018 and 2019. Meanwhile, market expectations call for no additional hikes this year and only 2 total hikes through the end of 2019. *The Fed and the market appear to have exceptionally divergent opinions on the probability of rising short-term rates.*

Fed Projections vs. Market-Implied Fed Funds Target Rate



Source: Bloomberg, as of 8/25/17

To be fair, the Fed's projections historically haven't been very accurate. Several years prior to 2015's long-awaited "liftoff" from the zero bound, the Fed had consistently projected near-term rate increases that didn't happen. At the time, market expectations were ultimately proven correct. We believe this time will be different

Caution Ahead

This time we think the Fed, and not the market, is the more reliable forecaster for the following reasons:

- The Fed is now firmly in the middle of a tightening cycle, and historically this means they keep steadily raising rates until conditions change or the Fed Funds rate reaches its terminal level (currently estimated at 3%).
- The current post-crisis expansion is one of the longest uninterrupted growth periods in American history, and a recession is becoming statistically more likely as time passes. Given that rate cuts are one of the Fed's most powerful weapons in fighting recessions, the Fed is likely concerned about stockpiling sufficient "ammunition" in the form of higher rates that can be reduced when the economy begins to deteriorate.
- Official communications are clearly signaling the Fed's intent to slowly begin reducing its massive post-crisis balance sheet. This effectively represents another, more indirect path towards tightening monetary conditions.
- From 2009-2015, the Fed resisted pressure to increase rates by citing a need to first see signs of economic improvement through rising employment and inflation. The former objective has been met while the latter remains elusive, yet the Fed has nonetheless continued raising rates – a sign they are indeed more concerned about replenishing their "monetary policy toolbox" ahead of the next inevitable downturn.

The market's rationale for undercutting the Fed's projections seems based on a more pessimistic view of the economy's growth and a belief that inflation has stagnated at low levels, which would discourage more aggressive Fed action.

Ultimately, we believe the Fed's reasons for continuing to hike/reducing its balance sheet are compelling. Moreover, with the upcoming 2018 expiration of Fed Chair Janet Yellen and Vice Chair Stanley Fisher's terms, there is a risk President Trump will nominate successors who skew towards more rules-based methods for determining the proper Fed Funds rate (e.g., the Taylor Rule). These rate-setting methods would typically call for a more aggressive pace of hikes, a risk that cannot be completely ignored.

Treasury Partners Outlook

Although all portions of the short-term Treasury curve are lagging the Fed's forward rate projections, the disparity is most apparent in the 3-5 year sector. This is the part of the curve which could bear the greatest level of volatility if the Fed carries through on its forecast. As a result, at this time we are not aggressively extending maturities as we had been for many years following the financial crisis. Depending on specific portfolio maturity structures, we'll naturally continue to reinvest to avoid a buildup of excess liquidity.

As always, we are carefully monitoring the market for changes, and will consider extending maturities more aggressively if the market begins to build in more of a "cushion" to account for Fed action.