ALTERNATIVES

Fed Tapering Could Be Off The Table Until 2014

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Michael Materasso
Senior Vice President,
Head of Insurance Asset Management
Franklin Templeton Fixed Income Group®

Sometimes, hindsight is insight. The mystery of why the Federal Reserve didn't start pulling back or "tapering" its prolonged quantitative easing program at its September policy meeting seems more clear now that we've experienced the fallout from the fraying of US fiscal policy soon thereafter, including a 16-day government shutdown in October. Given that the Congressional agreement reached in October only funds the government through January 15 and extends the debt ceiling through February 7, more political grandstanding—and economic consequences—could lie ahead. That all being the case, our Fixed Income Policy Committee Co-Chair, Michael Materasso, who also manages Franklin Total Return Fund, a multisector, fixed-income fund focusing on government and corporate debt securities, as well as mortgage- and asset-backed securities, thinks tapering could be off the table until 2014, although there's a slim chance it could happen in December of this year if economic data through year end prove supportive. Materasso shares more of his perspective.

The last-minute breakthrough in the recent US political impasse represented an extension of, rather than a true resolution to, the chronic dysfunction in the US Congress. This lack of ability to attain a consensus agreement on the nation's priorities seemed to justify the Fed's decision in September to postpone the tapering of its asset purchase program. Looking ahead, we don't see an easy or quick resolution to the situation and, for that reason, our view is that the Fed will likely be relatively slow to taper.

The prospect of another round of political wrangling lies in the not too distant future. Overall, we believe that this puts more pressure on economic data. If the data released between now and the Fed's December meeting has a consistent, strengthening tone, it is not outside the realm of possibility that we could see a December start to the taper. With the release of the (pre-shutdown) September payroll report, however, that seems to be unlikely. Instead of the hoped-for improvement, the data were relatively soft. We believe it is more likely that the Fed will take a wait-and-see approach in light of a looming political showdown.

In an environment where many investors are influenced by headlines, we think the uncertainty over the US government's fiscal position represents more noise than a fundamental shift in the economic landscape. We view the volatility that accompanies these discussions as an opportunity to add to positions that we hold with strong conviction and doubt that it will have any long-term meaningful impact.

Overall, many companies have strengthened their balance sheets considerably over the past few years while maintaining adequate amounts of liquidity. We recognize that many firms may be hard-pressed to maintain the growth rates we've seen over the past few years. However, we believe the corporate debt sector has the potential to do well in an extended period of weak and uneven growth where interest rates remain low for some time. For these reasons, we think investment-grade and high-yield corporate bond holdings continue to present attractive investment opportunities.

In addition, our view is that the housing industry should be able to sustain its recovery. Even though interest rates have risen in recent months, rates are still near historic lows, and we think commercial and residential real estate stand to gain. As a result, we also continue to maintain our constructive view on the commercial and residential mortgage-backed securities sectors.

Municipal bond yields have risen substantially in recent months due to a number of factors, including individual investor fears of rising interest rates and negative headlines stemming from Detroit's widely publicized bankruptcy filing. In certain cases, tax-exempt yields of even investment grade-rated borrowers approached or exceeded their taxable equivalents. Overall, we view this as a case of technical factors driving yields to highly attractive levels. Given the continuing dislocation in that sector and the ongoing improvement in the fundamentals of many municipal issuers, we feel that there continue to be attractive opportunities within the sector.

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What are the Risks?

All investments involve risks, including possible loss of principal. Interest rate movements and mortgage prepayments will affect the fund's share price and yield. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in Franklin Total Return Fund adjust to a rise in interest rates, the fund's share price may decline. Changes in the financial strength of a bond issuer or in a bond's credit rating may affect its value. The risks associated with higher-yielding, lower rated securities (commonly called junk bonds) include higher risk of default and loss of principal. Investment in foreign securities also involves special risks, including currency fluctuations, and political and economic uncertainty. Derivatives, including currency management strategies, involve costs and can create economic leverage in the portfolio which may result in significant volatility and cause the fund to participate in losses (as well as enable gains) on an amount that exceeds the fund's initial investment. The fund may not achieve the anticipated benefits, and may realize losses when a counterparty fails to perform as promised. These and other risk considerations are discussed in the fund's prospectus.