Fed in Holding Pattern, but for How Long?

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At its October 29-30 policy meeting, the US Federal Reserve (Fed) again put off the so-called "tapering" of its $85 billion-a-month asset purchase plan, now over a year old, until some future date. In an official statement released at the conclusion of the meeting, the Fed cited fiscal policy issues as restraining growth and said it will continue its quantitative easing program (known as "QE") until the job market improves "substantially." Christopher Molumphy, chief investment officer of Franklin Templeton Fixed Income Group®, believes the Fed won't likely ease off the liquidity pedal until the first quarter of 2014 and thinks any outright increase in interest rates probably won't be seen until 2015. More from Molumphy on Fed policy and what it might mean for the interest-rate markets.

The October Federal Open Market Committee meeting held no real surprises for most market participants. It had been a relatively short period of time since the previous meeting in September. On top of that, the 16-day US government shutdown in the intervening period resulted not only in distortions in some of the economic data, but also data release delays.

More importantly, when we look at the Fed and what we think it might do going forward, it's important to note that we have seen some data evidencing a bit slower economic growth over the past several months, as well as a bit of a slower pace of job creation. Both of these factors would lead toward a delay in Fed activities. So in terms of the beginning of the tapering process, reducing QE, we are looking at likely the first quarter of next year. Furthermore, we think the eventual timetable for when the Fed will start increasing the federal funds rate will likely be pushed to 2015. So what we are looking at is lower short- and intermediate-term rates, for longer than perhaps we had previously thought.

We believe short-term rates, again driven primarily by the Fed, are likely to remain at zero for another year, if not a year and a half. Inflation is a key driver of long-term rates, and it has been benign, running between 1% and 2% on an annualized basis.[1] Our view is that it will remain fairly benign for the foreseeable future. Hence, any increase in longer-term rates is expected to be relatively muted as well.

Looking out several years, however, our view is that longer-term rates will likely be higher. The reason is twofold. First, the total amount of the US national debt, the gross debt, is now in excess of $17 trillion and growing. That's a concern. Second, the Fed, with its QE programs, has been effectively printing money roughly to the tune of $3 trillion and, ultimately, we should experience inflation as a result. We think that combination will eventually result in higher long-term rates.

Political Déjà Vu?

On the fiscal side of the economic equation, the political impasse that shuttered the government for 16 days in October caused a lot of handwringing, economic fallout and a dose of market volatility. Congress agreed to keep the government running only until January 15 and extended the debt ceiling until February 7. Our sense is that the outcome of the upcoming political debates will be somewhat different this time than it was in October, although we could see similar volatility in the marketplace as we move into 2014. A bipartisan Congressional Budget Conference Committee was formed to assemble a potential blueprint for a solution, and its members are supposed to report back by December 13. We're not overly optimistic that they're going to come back with a grand solution, but we should at least get a sign of some sort, hopefully one of progress.

As we move into 2014, we do not think there will be another US government shutdown. That didn't work so well this last go-round, so we're pretty confident that the government should remain up and running and some resolution will be worked out. The February 7 debt ceiling deadline is a soft deadline, in our view, and could see another extension until mid-March. However, there could be some contentious negotiations around that debt ceiling.

We don't have significant fears of a US default on sovereign debt, but the uncertainty could create market volatility in the first quarter of the year. Looking longer term, it would be positive to see some advancement in both the budgetary process as well as a plan to deal with the long-term debt. For now, we have to wait and see if that actually comes to fruition.

When we look back at this past episode of political brinkmanship, the impact on both financial markets and the overall economy was relatively small. Perhaps it wasn't a great surprise from the market's point of view because we've been down this road before, and it seems many investors are becoming somewhat numb to the political posturing.

Certainly, confidence, both with respect to the consumer but also small business, has suffered some negative impact. And then perhaps even more importantly, the reputation of the US as a debtor in the global financial markets has been negatively affected. It's something we need to be concerned about. The recent US political impasse hasn't been particularly positive in terms of the confidence the rest of the world has in the US government's management of its debt. There's been a bit of tarnish on our reputation.

Areas of Opportunity

We see a number of areas of opportunity in the fixed income universe, despite the monetary and fiscal policy uncertainty that lies ahead. Generally speaking, yields across the board are low on a historical basis. We think corporate debt securities in particular represent value in today's marketplace. Fundamentals, whether they be investment grade, high yield or leveraged bank loans, look pretty good from our perspective. Cash on corporate balance sheets, improving earnings and low expected default rates present a good investment case, particularly when combined with valuations, which to us seem very reasonable in many cases.

We also continue to see opportunities in the global fixed income arena. A number of countries have continued to have higher yields than we see in the US, with better economic growth prospects as well as superior financial conditions and prospects for currency appreciation.

I would be remiss not to mention an area of fixed income that has really been beaten up significantly over the past couple of quarters: municipal bonds. When we step back from some of the individual situations, by and large, most cities and states have done a very solid job over the past several years getting their financial houses in order. Broadly speaking, the asset class looks fundamentally in pretty good shape to us. With the valuations in today's market, given some of the media coverage and the broad carnage, we think municipal bonds represent good value as an asset class as we look ahead.

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What Are the Risks?

All investments involve risk, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. When interest rates rise, bond prices fall, and the converse is true. Floating-rate loans and high-yield corporate bonds are rated below investment grade and are subject to greater risk of default, which could result in loss of principal—a risk that may be heightened in a slowing economy.

Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments.

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1. Source: US Bureau of Labor Statistics, September 2013.

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