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Beyond Bulls & Bears

Fixed Income Outlook: Moving From Zero

July 16, 2014

Some prior market prognostications of rising rates have proven slow to play out as global central banks, namely the Bank of Japan and European Central Bank (ECB), have continued to ramp up easing measures and the US Federal Reserve (the Fed) has only slowly begun to lay off the gas pedal recently. While one of last year’s big themes in US fixed income was the so-called “Great Rotation” as fears of Fed tightening drew investors away from the asset class in favor of equities, some in the press have dubbed this year’s action as the “Great Reflation” as investors no longer seem to be following previous either/or allocation patterns. Christopher Molumphy, chief investment officer, Franklin Templeton Fixed Income Group®, and Roger Bayston, senior vice president, Franklin Templeton Fixed Income

Group®, offer their perspective on the markets year-to-date, and why they believe investors shouldn't become too complacent about a zero-interest rate environment in the US, particularly if economic growth, employment and inflation accelerate.

The Fed recently released its updated economic projections, which offer us some insight into how policymakers view the overall economic backdrop. In June, the Fed forecast roughly 3% economic growth for the rest of this year and 3.0 – 3.2% for 2015.[1] This is roughly in line with the broad market consensus, but it is worth pointing out that it is greater than the pace of economic growth we've seen over the past five years, which averaged roughly 2%.[2] The Fed continues to see a gradual improvement in the rate of unemployment, forecasting roughly 6% at year end; this improvement trend is expected to continue, falling to 5.4 – 5.7% by year-end 2015. In addition, the Fed also released its expectation for a long-run or full-employment rate, putting the jobless rate in the neighborhood of 5.2 –5.5%, which it currently forecast should be reached in 2016.[3]

Turning to inflation, Federal Reserve officials focus on Personal Consumption Expenditures (PCE) over the Consumer Price Index (CPI) in their projections, and are looking at PCE inflation of roughly 1.5 – 1.7% in the fourth quarter of this year and staying at 1.5 – 2% through 2016.[4] Interestingly, we just received an update on PCE data through May, and it is already running roughly within this range. So, the Fed's projections effectively show no increase in the pace of inflation over the next two and a half years. Our view is that if you think about fairly strong US economic growth in the neighborhood of 3%, combined with a gradual continued improvement in the employment figures, the expectation for inflation to stay at current levels may be somewhat optimistic, at least given historical context. The Fed also announced that it would continue to reduce its asset purchase program known as quantitative easing or "QE" to $35 billion a month in July and that if the economy progresses as it expects, it will end its monthly asset purchases in October.

More importantly is the question of when the Fed will finally increase the federal funds rate from close to or at zero, and then how quickly it will be raised going forward. The Fed has reiterated its two objectives are centered on inflation and unemployment.

In terms of when the QE program will end and the beginning of interest rate increases will begin, the Fed has repeated the phrase "considerable time." While that feels vague, Fed officials have provided some guidance. According to minutes from the Federal Open Market Committee (FOMC) meeting of June 17-18, the median forecast of FOMC members for the benchmark federal funds rate was 1.13% by the end of 2015 and projected to reach 2.5% by the end of 2016. The general market consensus seems to be in agreement with those projections.

Our view is that the Fed may be hard-pressed to keep the Federal funds rate at zero for another 12 months in the context of stronger growth and employment.

The investment-grade sectors of the US fixed-income market, which include investment-grade corporate bonds and agency mortgage-backed securities, have benefited from the trend of lower interest rates since the beginning of the year.

The Fed is tapering its purchases in the mortgage-backed securities markets and, if the US economy continues to strengthen in line with the Fed's expectations, is expected to be done in October if the current pace continues. It should be noted the agency mortgage-backed securities market will at that time be operating in an environment of no explicit or implicit support by US government agencies for the first time in a very long time.

Fannie Mae and Freddie Mac historically have provided massive support by purchasing mortgage bonds into their portfolios; after the global financial crisis hit, the Fed assumed that role through their quantitative easing ("QE") programs. We believe the Federal Reserve should continue to reinvest principal for mortgage bond prepayments and maturities into the agency mortgage pass-through market. So, it should still have a market presence going forward even as QE winds down. The Fed's portfolio of mortgage bonds is quite large—over $1.5 trillion in assets—but policymakers claim they will not be liquidating these investments anytime soon. I would tend to believe them. The Fed's goal for buying the assets in the first place was to help reduce long-term rates and provide a favorable backdrop for mortgage financings. So to sell the assets and contribute to possibly pushing long-term rates higher, including mortgage rates, would defeat that purpose in the near term.

At this point, the outlook for the agency mortgage-backed securities (MBS) market is a bit mixed, in our view. Conversely, there is less support from the Fed through the reduction of its buying program. Normally this would be met with a bit more volatility in the market as the marketplace seeks to absorb MBS issuance once the Fed completes its QE3 operations; however, with the large amount of global liquidity that is moving around the world now muting market volatilities and still encouraging a level of risk-taking, the agency mortgage market has been performing well. I guess it's always a good reminder that these particular markets are not generally exposed to default risk as either their implicit or explicit backing of the US government remain at a place where investors continue to be insulated from corporate credit risk. The deeper we move along the credit cycle, the more important that attribute possibly will become for fixed-income investors.

The agency MBS sector includes Ginnie Mae, Fannie Mae and Freddie Mac. Ginnie Mae has the explicit full faith and credit backing of the US government. Fannie Mae and Freddie Mac are under conservatorship, so while their backing remains implicit it has moved closer to an explicit guarantee. At some point there will likely be reform to existing US housing finance that could change the current structure of these guarantees, but until that time the market expects government support for these sectors to remain. Prepayment risk on agency mortgage securities remains quite low and this has pushed the durations or interest rate sensitivity of the sector to high levels. We expect prepayment risk to remain low unless and until the 10-year Treasury yield drops below 2%, which would also push down mortgage rates and open up refinancing opportunities for mortgages issued during the past five years.

The other credit-sensitive sectors of the mortgage markets, including non-agency residential mortgage markets and the commercial mortgage-backed securities markets, have performed pretty well since the start of the year. The theme here is the same: low market volatility and continuously improving fundamentals in the underlying residential and commercial real estate markets. Despite their generally good performance, issuance in these markets is way down from the levels prior to the financial crisis. There seems to be healthy demand from investors.

The biggest question we get is really: Now that we’ve had years of low short-term rates and solid performance in the fixed-income markets, what’s next for investors? From a multi-sector viewpoint, we continue to like the fundamentals within several credit-related fixed-income markets. Diversified and defensive remain themes that we are focused on at the moment.

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1. Source: “Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents,” US Federal Reserve, June 18, 2014.

2. Source: US Department of Commerce, Bureau of Economic Analysis. Seasonally adjusted at annual rates.

3. Source: “Economic Projections of Federal Reserve Board Members and Federal Reserve Bank Presidents,” US Federal Reserve, June 18, 2014.

4. Source: Ibid.

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