# Reading Fed Tea Leaves

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Monetary policy is of keen interest to fixed income investors, and the US Federal Reserve (Fed) has been known to be particularly obtuse when it comes to interest-rate talk. One thing is clear: The Fed is winding down its longstanding quantitative easing (QE) program. What’s not so clear: when the Fed will actually raise short-term interest rates. Christopher Molumphy, chief investment officer, Franklin Templeton Fixed Income Group®, attempts to read the tea leaves from the September Fed policy meeting and offers some perspective on the state of fixed income markets today—including how he’s positioning his portfolios for an eventual rate rise.

The September Federal Reserve (Fed) policy meeting held no real surprises for us. In terms of formal policy, the Fed announced the continual reduction of its quantitative easing (QE) program, bringing it down by another $10 billion per month, as market watchers generally expected. At the next meeting at the end of October, the current market expectation is that the Fed will move out of QE entirely. The Fed also retained its accommodative stance.

The central bank's updated forecasts and the hour-long Q&A session with Fed Chair Janet Yellen after the meeting did provide some takeaways to think about. The market was looking for the Fed to potentially elaborate on or even remove its previously used language of "considerable time period" in terms of when QE would end and when an actual increase in its benchmark interest rate would begin. The Fed did not remove that language, which the market seemed to interpret on the margin as "OK, they are going to continue to be accommodative." Additionally, Yellen, while making note of the unemployment rate continuing to come down, also pointed out the significant underutilization of labor resources. In other words, she was talking about the slack in the labor market. Clearly, Fed policymakers view that as still an issue.

### A Look at the Fundamentals

Looking at the Fed's economic forecasts, interestingly, its 2015 growth forecast is actually a bit lower than what the market seems to be forecasting. The Fed is looking for growth below 3%, which is a bit more sluggish than the market consensus. In terms of unemployment, the Fed sees it continuing to come down, reaching what in its view is full employment roughly sometime in 2016, ranging from 5.1%–5.4% by the end of that year. In terms of inflation, the Fed continues to believe it will remain benign. The Fed is looking at 2% or lower inflation all the way through the end of 2017. From our viewpoint, that's a pretty optimistic inflation forecast—maybe too optimistic.

Lastly, the Fed made projections for the federal funds rate, the key short-term interbank lending rate. It raised its median estimate for the federal funds rate to 3.750% at the end of 2017. Looking at its projections, the vast majority of market participants think that the Fed will, in fact, begin to raise the Fed funds rate next year, in 2015. If you put it all together, we think it's still a pretty accommodative Fed as we go forward.

We spend a lot of time focusing on underlying long-term fundamentals when we look at the investment implications for our fixed income portfolios. The key factors we look at are certainly similar to what the Fed is focusing on: inflation, economic growth and labor markets. Those are critical. The labor markets are vital when determining the broader economy because, ultimately, in the United States, the consumer represents some 70% of overall economic activity. So as the labor markets improve, the outlook for the consumer and, hence, the overall economy improves. The Fed's statutory mandate is to foster maximum employment and price stability, so the labor market is a key factor in the Fed's decision making. And—we heard this from Chair Yellen—as the labor markets improve, we are getting closer to the Fed ultimately raising rates. So we see that happening down the pike.

In terms of US economic growth, it's our view that GDP growth is likely to tick up either at or near 3% over the coming four to six quarters, and that's a result of a stronger consumer, gradually improving real estate markets, and a solid corporate environment. We think that should set a positive backdrop for financial assets.

Clearly, inflation plays a large role in fixed income instruments. We see fairly benign inflation, albeit probably ticking up as the labor market improves. That said, we are probably not as optimistic as the Fed on the inflation front. The Fed sees inflation staying at or below 2% going out to the end of 2017. In our view, should we see 3% economic growth (or close to it), combined with an improving labor market, it may be a bit too optimistic to think inflation will stay at or below 2%, looking out several years.

### Positioning for an Eventual US Rate Rise

Our view is that risk management within the current market environment (or really any environment) should always start with diversification,[1] even within one's fixed income portfolio. Diversification by asset class, by maturity, by credit quality, even by geography, is crucial, in our view. Then we get the question that is quite a bit specific to interest-rate risk: How do you deal with that? You will want the counsel of a financial advisor, but we suggest discussing one of two broad strategies. The first is what we view as a high-quality, lower-risk strategy that focuses on US Treasuries, asset-backed securities, mortgage-

backed securities and low-duration assets. That is one way to position portfolios to deal with the eventuality of rising rates. Of course, there’s a trade-off: Lower risk generally also comes with pretty subdued yield and return potential.

The second approach, which requires a higher risk tolerance, would be to consider a blend of assets and asset classes that trade based on factors not only tied to interest rates. For example, that might include high-yield corporate bonds, emerging-market debt instruments, leveraged bank loans and global bonds. We think a portfolio constructed with those types of assets can be used to seek potentially strong performance in a rising rate environment. Admittedly, higher risk also brings more potential volatility.

The leveraged loan market in particular has seen a great deal of investor demand over the past couple of years. We are still reasonably constructive on leveraged loans (also called bank loans) today for two principal reasons: Leveraged loans tend to trade with the broader economy, and our outlook is relatively positive for the broader US economy over the next 12 to 24 months. That should bode well for leveraged bank loans, in our view.

Bank loans are also generally very low in duration,[2] so they have the potential to do well in a rising rate market. Healthy demand over the past three years or so has meant valuations are not quite as attractive as they once were. We have seen a pickup in issuance, so perhaps the quality isn’t quite as solid as it might have been, but overall, we think the quality of bank loans relative to the valuation is still reasonably attractive looking forward.

### Fixed Income Valuations: Not as Cheap

Fixed income valuations aren’t particularly cheap at this point, broadly speaking. Many sectors of the market have done well, and appear fairly valued to a bit overvalued, based on long-term historical metrics. For example, high-yield corporates are currently trading at a spread over Treasuries of roughly 4.5 percentage points, and that’s versus a nearly 6% long-term average.[3] Leveraged bank loans have roughly a similar spread, which is also a little bit on the rich side historically.

Having said that, it’s back to fundamentals. When we look at the corporate credit market, for example, we see fairly healthy fundamentals and, broadly speaking, a lot of liquidity. We do need to be careful about looking at valuation metrics within what has been an

atypical or unusual market; central banks globally have pumped some $9 trillion of liquidity into the marketplace over the last six years. Because of that we have had artificially low yields, and you can't look at valuation metrics in a true fashion. In our view, that set of dynamics is not necessarily going to change over the near to intermediate term. So, when you put all that together, we are still pretty constructive on the majority of spread sectors in the fixed income marketplace, particularly over the next, say, 12 to 18 months.

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### What Are the Risks?

All investments involve risks, including possible loss of principal. Changes in interest rates will affect the value of a portfolio and its yield. Bond prices generally move in the opposite direction of interest rates. Thus, as the prices of bonds in a portfolio adjust to a rise in interest rates, the portfolio's yield may decline. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in developing markets involve heightened risks related to the same factors, in addition to those associated with their relatively small size and lesser liquidity. 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.

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1. Diversification does not guarantee profit or protect against risk of loss.

2. Duration is a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates. Duration is expressed as a number of years.

3. Source: Bloomberg LP, JP Morgan High-Yield Bond Index STW Global, as of 9/22/14. Indexes are unmanaged and one cannot directly invest in an index. **Past performance is no guarantee of future results.**

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