In the Know: March FOMC Meeting and Interest Rate Moves

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In the Know: Professionals at Franklin Templeton Investments offer a quick but insightful update on a pressing investment topic.

Franklin Templeton Fixed Income Group's Christopher Molumphy offers his analysis of the March 17-18 Federal Open Market Committee (FOMC) Meeting, where he sees US interest rates headed next, and why he thinks the 10-year Treasury yield could remain lower for longer than perhaps it should.

What were the key takeaways from the March Federal Reserve (Fed) meeting?

In the Fed's most recent statement, policymakers reported that recent economic activity slowed a touch, but the big buzz in the marketplace was the Fed's removal of the word "patient" in its language about its approach to future interest rate hikes. The Fed stated that "consistent with its previous statement, the Committee judges that an increase in the target range for the federal funds rate[1] remains unlikely at the April FOMC meeting." That means June could be the first meeting where the Fed starts raising interest rates. In the past, Fed Chair Janet Yellen has stated that they would give a warning two meetings before a rate increase, so June seems like the first possibility for that to occur. That said, it doesn't mean rate hikes will occur then. The Fed also stated it will be watching the data—so to us it seems more likely the first rate increase will occur in September.

Were there any significant changes in the Fed's economic projections?

With respect to US economic growth, the Fed lowered its growth expectations slightly at the March meeting to a range of 2.3%–2.7% in the current year vs. its previous forecast of 2.6%–3% in December 2014. So, the mid-point of its forecasted range moved from 2.8% to 2.5% for the current year. The Fed mentioned declining exports due to a stronger dollar as the primary factor for the lower growth projection. We also note that severe winter weather in the Northeast region of the United States and port closures due to strikes on the West Coast also could be contributing factors to slowing growth in the first quarter of 2015.

The Fed's inflation expectations were also lowered from three months ago, which is not surprising given the drop in the price of oil. What we think is noteworthy is that the Fed expects core inflation (excluding energy) in a range of 1.3%–1.4% in 2015 and 1.5%–1.9% in 2016, both lower than its December 2014 projections. The Fed currently believes inflation will stay contained through 2017, although we don't necessary agree with that view.

Additionally, the Fed stated that the United States should see what it views as "full employment" this year, and forecasted the unemployment rate to land in the range of 5%–5.2% in late 2015.

Why did stocks and bonds rally even though the Fed seemed to set the stage for a rate hike?

I think the big takeaway of the March Fed meeting from the markets' perspective is that the Fed's statements were interpreted to mean there would be a very slow pace of interest rate increases when they do occur. Yellen noted that while there is no "patient" in the Fed's language, that doesn't mean they will be "impatient" when it comes to raising rates. The Fed will likely be accommodative, and their actions will be data dependent. As noted, our view is that the Fed probably will start raising rates this year, and our best guess is it will begin in September. With unemployment on the decline and approaching full employment levels, we think the Fed funds rate is unlikely to stay at zero. What's more important, in our view, is how conservative the Fed will be in its actions. Looking back to 2004, the last time the Fed was in a tightening cycle, it raised interest rates 25 basis points (0.25%) at all subsequent meetings over a two-year period. I don't think the Fed will do anything like that this cycle.

What's your take on the strength of the dollar and its impact on the economy?

My initial thought is that, clearly, the dollar is having some impact on US economic growth, but it's relatively minor. The impact of the strong dollar has gotten a lot of attention, but in our view it's more of a factor for corporate earnings among multinationals than for US gross domestic product (GDP) overall. The United States is largely domestically driven; two-thirds of GDP is driven by the consumer, so consumer health and the labor market are larger components when you look at overall economic growth. The strength of the dollar has an impact, but only on the margin.

Why are we not seeing wage inflation if we are already near full employment?

Full employment is not an unemployment rate of 0%. There will always be some people looking to change jobs, commonly referred to as frictional unemployment. The United States is near full employment today, but we haven't seen wage inflation take root. One reason is the labor participation rate, or the percentage of people either employed or looking for work, is at very low levels that we would typically see post-recession. We think this could partly be explained by the legions of baby boomers deciding to retire. Whatever the reason, we don't see the participation rate moving much lower in the near term, which would keep wage inflation moderate.

So when will Treasury yields likely start increasing?

We think short-term rates will likely start to move up this year, but the key is that it will be gradual. Longer-term rates are a little trickier. Our view is that the yield on the 10-year Treasury note should be higher given current economic conditions. It likely will move higher as the year progresses, but there are a number of reasons why long-term rates could remain lower than perhaps they should be for a while. Lower oil prices are containing the current inflation outlook, although we could see that influence dissipate in time. Economic growth is not gangbusters; in our view it's not enough to trigger higher inflation or higher interest rates near term. The significant move up in the US dollar also creates downward pressure on import prices, which further suppresses inflation.

We are discussing the possibility of the Fed tightening rates, but it's also important to remember that global liquidity persists. Japan remains engaged in a large quantitative easing (QE) program and the European Central Bank (ECB) is only a few weeks into its own QE program, which is worth around €1 trillion. Central bank easing outside the United States, we think, should likely continue to suppress global interest rates. We don't see that changing over the next year. When we look at a 10-year US Treasury yield under 2%, we think it has to go higher. But when we have the Japanese 10-year government bond yield around 0.3%, the German bund yield around 0.17% and Swiss government bond yields going negative[2] the bottom line is that ultimately US rates will likely move higher, but we think they could remain relatively low for a prolonged period of time given the environment we are in.

What are the investment implications?

In our view, diversification[3] in fixed income investing makes a lot of sense in this market, and that includes global exposure. We see selective opportunities in global credit and a favorable economic backdrop in the United States for corporate credit broadly, which we believe should be constructive for investment grade as well as high yield (corporates) generally. We also favor bank loans (leveraged loans) as well as municipal bonds in an environment of solid growth.

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1.The federal funds rate is the overnight rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution.

2. Source: Bloomberg, as of March 2015.

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

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