In the Know: Fed Policy and Fixed Income

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

The conclusion of the US Federal Reserve (Fed) policy meeting in June held few surprises for market watchers, leaving interest rate hikes still somewhere off in the distance. Roger Bayston, senior vice president, Franklin Templeton Fixed Income Group®, shares his insights on the Fed meeting and what it means for the fixed income markets.

We are halfway through the year and the Fed has held off on raising interest rates. What is your team's view on Fed policy and interest rates?

We at Franklin Templeton Fixed Income Group have been expecting the Fed to raise short-term interest rates in 2015, and the June Federal Open Market Committee (FOMC) meeting didn't change our outlook for rates to move higher by year-end. The two things the Fed is most concerned about are employment and inflation. Given the current US unemployment rate (5.5% in May), the fact that we are several years removed from the financial crisis and have seen positive economic data and a rebound in household wealth, the Fed probably doesn't see a need to maintain short-term interest rates at zero at this point in the cycle. While we haven't seen enough inflation pressure to say that we think the Fed is behind the curve, we do expect labor costs to accelerate, likely in the near term, and it's our belief the Fed will have to raise rates, most likely in the third quarter. The Fed has been telegraphing that it is going to be raising rates for some time, but the market doesn't seem to want to believe it, so we expect to see some market volatility when it does happen, whether it occurs in September or even at the December policy meeting. We believe the Fed has been trying recently to communicate what may happen *after* it begins lifting short-term rates. Policymakers are indicating that when they start raising rates, it's going to be gradual, and it's going to be data dependent.

Can you discuss the changes that have occurred in the Fed funds market since the financial crisis? Does this impact the Fed's exit strategy?

The Fed has kept the Fed funds rate—the overnight interbank lending rate—at 0% for a number of years now and has a number of tools that it has used in its quantitative easing program. The Fed has telegraphed to the market that it is going to potentially raise short-term interest rates this year. It also holds a large portfolio of securities, including US Treasuries as well as agency mortgage-backed securities (MBS) that eventually will come into the equation when we talk about monetary policy tightening.

The Fed owns $1.7 trillion in agency MBS. Can you talk about the impact of the Fed's unwinding on the MBS market?

We've been paying close attention to what the Fed has been saying, and its stated position is that it doesn't intend to sell its MBS position. One feature of agency mortgage pass-throughs is that they amortize monthly. As each household makes its monthly mortgage payment of interest and principal, the balance begins to be whittled down over time. So, as an amortizing portfolio, it won't likely last all the way to the 30-year maturity term that exists on the bonds. We see the real question as not whether the Fed sells these assets into the marketplace—which we don't think it will—but when it will stop reinvesting principal. Right now, the Fed is investing the principal paydowns and they are quite a presence in the marketplace. When the Fed stops reinvesting principal in the market, it will be the first time in a long time that we don't have some sort of US government agency—whether it was previously Fannie Mae or Freddie Mac or now the Federal Reserve—being involved in the agency market. So we expect to see a little volatility as a market for buyers and sellers is found.

In your view, does US fixed income exposure still make sense for investors today?

Even with rising US interest rates, the strength in the underlying US economy means that there are potential investment opportunities across the debt and equity markets. We like corporate credit, for example, within some of our multi-sector strategies as a defensive posture to take advantage of a stronger economy and the fact that companies are able to pay coupon interest payments.

Investors are very concerned about the interest rate cycle and what it means for fixed income investing, but I think they should also be concerned about the credit cycle—when credit is more or less available. In terms of the credit cycle, we are clearly well past the depth of the financial crisis. We've had record issuance of investment-grade corporate bonds in the United States. The Fed's zero interest rate policy has driven investors out along the yield curve and down the credit structure in an attempt to achieve income and yield. We still have opportunities in front of us, in our view. We still like credit in portfolios, as the strength of the US economy and the low-rate environment have helped corporations reduce leverage.

In light of our expectations for higher interest rates ahead, we would point out that we maintain a defensive posture within our portfolios in terms of duration, which measures sensitivity of the price of a fixed income investment to a change in interest rates, expressed as a number of years. We expect that as the Fed begins to raise short-term interest rates, we likely will see the yield curve flattened, with short rates having a bigger impact coming up, rather than longer rates moving higher.

The media has made much of a supposed lack of liquidity in US Treasuries, stemming from regulatory changes that occurred in the wake of the 2007-2009 financial crisis. What's your take?

The regulatory changes are real, and we have been dealing with this for a number of years. They have impacted Wall Street and the dealer community, but the impact has been felt in the fixed income markets too. The fixed income markets are over the counter in nature, which means that there's an intermediary that sits between the buyers and sellers. Those regulatory changes have made it much more expensive for traditional intermediaries—Wall Street and investment banks— to engage in bond dealing activity, putting their own capital at risk. As a result of the change in dynamic, sometimes the market has moved more because of certain events than it would have in the past. I think all fixed income investors are going to have to adjust to this.

And how are you dealing with a potential liquidity squeeze?

If you consider liquidity as the ability to sell out of a position, in our view, liquidity has not been particularly strained, although we have seen some bouts of short-term market volatility.

Generally speaking, I think instruments that have had high credit quality will remain fairly liquid, and we really won't see liquidity challenges present themselves probably until we see a significant shift in the credit cycle. When the credit cycles change, and we end up having individual names having trouble with payments, then we are probably going to see that liquidity issue come to bear. We think diversification within fixed income will be important when volatility occurs.

As fixed income investors, we have to build more tools and use different types of tools when managing our portfolios, allowing ourselves to remain more liquid in some of our short-term investments in order to keep what we believe to be a prudent level of risk given the changes in liquidity in the marketplace. At times, our strategy has been to carry more liquid instruments in our portfolios—cash or other short-term instruments—to try and take advantage of volatile periods.

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