A More Accommodative Fed

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The US Federal Reserve didn’t find a compelling reason to raise interest rates at its March policy meeting, maintaining its benchmark short-term interest rate (fed funds rate) in the range of ¼ to ½ percent. While this was not a surprise to most market participants, policymakers communicated a more accommodative stance, suggesting a modest course of only two rate hikes likely this year. Franklin Templeton Fixed Income Group’s Chris Molumphy talks about what this means for fixed income investors, and the long-term risk he sees that many market participants seem to be overlooking.

There were no major surprises coming out of the March Federal Open Market Committee Meeting, though it certainly did reinforce the very dovish bias the Federal Reserve (Fed) seems to have. We anticipate extremely accommodative policy to remain in place for the foreseeable future.

March Fed Meeting Takes More Accommodative Tone

When analyzing the specific forecasts the Fed updated at its March policy meeting, clearly the biggest shift is the update to the fed funds forecast for the end of 2016 and to some extent the forecast beyond that. What we essentially saw was a forecast that conveyed two tightenings over the course of 2016—two 25-basis-point increases in the federal funds rate. In December 2015, the Fed had communicated a cycle of four likely 25-basis-point increases, so this was a fairly significant change.

In terms of other updates we saw from the Fed's forecast, US gross domestic product (GDP) growth expectations for 2016 year were lowered slightly to 2.2% from 2.4% previously. We also saw inflation expectations scaled back a bit, with the forecast for Personal Consumption Expenditures (PCE) moving to 1.2% from 1.6% previously.

When you put all this together, the primary rationale for all of these changes (according to the Fed) reflects general expectations for weak global growth as well as concerns about financial-market volatility that came to a head the first couple of months of the year but continue to persist.

In addition to the meeting summary, Fed Chair Janet Yellen also addressed some important questions and concerns during the press conference afterward. In regard to some of the metrics on the US economy, she remained fairly positive about the US employment outlook, even mentioning wages and a slight upward bias was noted there. She continued to be reasonably constructive on the overall US economy, and pointed to some recent slight upticks in inflation. This backdrop is noteworthy in that it is accompanied by an extremely accommodative approach to monetary policy and a dovish bias as we look forward.

Global growth and other factors outside the United States can influence US employment and inflation trends, and thus, influence monetary policy. The Fed has referenced this specifically in its meetings during the first quarter 2016. Having said that, one of the key themes for investors in 2016 is this tremendous divergence between monetary policy in the United States and the rest of the developed world. Europe, Japan and even China, are pursuing even more accommodative policies than the United States. As the United States is moving (arguably at a slower pace) to a tighter policy, the rest of the developed world is continuing to ease.

As we go forward in 2016, we anticipate this monetary policy divergence will likely impact the US dollar; we would expect the dollar to appreciate against the major currencies over time. We would also expect to see an effect on longer-term US interest rates. We have already seen significant flows of global assets into US Treasuries this year, and in doing so, the level of long-term interest rates is being held down. When we look at US Treasury rates, fundamentally we would think they should be moving a bit higher, but again, that global flow into US assets is an offsetting force that we think could continue.

I’m not sure if the Fed’s most recent update necessarily changes our outlook a great deal, but it offers reaffirmation of what we might expect going forward. That is, we believe even more so that we will continue to see extremely accommodative policy.

Inflation Risk

The United States is a services-dominated economy and, hence, labor-inflation tends to drive overall inflation. We know labor markets have shown gradual improvement in the United States over the past several years and unemployment rates are nearing levels where we would typically expect to see wage inflation tick up somewhat. If unemployment continues to move down and job additions remain at anything close to the strong pace we have seen over the past couple of years, we think it should translate into wage inflation moving up. Average hourly earnings are currently running a little over 2% on a year-over-year basis, as of February. We wouldn’t necessarily expect that reading to rise demonstrably, but should start to tick higher over the course of this year and next. Frankly, it concerns us that extremely little focus has been placed on the possibility of wage inflation.

Looking specifically at the Fed's own projections, it tends to focus on PCE as the primary inflation metric; and even looking out over the next 2½ years, this metric looks to be at or below 2%, near where it is today. It's interesting that Chair Yellen, while agreeing with the notion that tighter labor markets generally lead to inflation, seemed to defuse any inflation-related concerns during the March meeting's question-and-answer session.

While the market consensus currently seems unconcerned about inflation, we know this could change quickly. Longer term, we certainly think higher-than-anticipated inflation is a potential risk for fixed income investors.

High-Yield Showing Signs of Stability

Looking at areas of the credit market more broadly, in December 2015 we saw media-fed volatility tied to a distressed hedge fund that negatively impacted the high-yield sector. In our view, the panic was to a large degree overblown. The sector actually hit a low point around mid-February, based on concerns for lower global growth as well as crude oil's slide below $30 a barrel, but has rallied significantly over the past month. Investors seem to be returning to so-called risk assets, driven by the reversal of those two factors; there has been less concern about diminished global growth, and oil prices have rebounded.

Fundamentals drive a sector like high-yield, and we see a positive environment for high-yield with valuations fairly valued to even slightly cheap. It's worth noting we are getting into the later stages of this particular economic cycle in the United States, but we don't necessarily see any end to the growth in the near term.

With respect to corporate credit overall, again we are reasonably constructive based on what appear to be reasonably positive economic prospects. When we look at investment-grade credit, high-yield and leveraged loans, we see a lot of the same characteristics or fundamental drivers. When we look at corporate balance sheets and liquidity, overall we believe the corporate credit markets are in reasonable shape, and general business trends point toward a fairly constructive outlook and reasonably healthy environment.

We think greater global central bank-generated liquidity will be a positive for the corporate credit sectors and economically driven parts of the market, at least in the near-to-medium term. This would include investment-grade corporate credit, high-yield and leveraged

loans. Additionally, based on the theme of monetary policy divergence on a global basis, we would anticipate that, all things equal, the US dollar will likely strengthen versus other developed markets' currencies, particularly over the longer term.

There have clearly been some issues affecting corporate credit over the past few months; energy and commodity-related credits have driven the marketplace in general and high-yield in particular. It's our belief that bond prices for many of these companies have been trading at distressed levels, with a worst-case scenario seemingly priced in. That is, looking at the prices of some of these distressed names, the upside/downside from current prices, in our view, is significantly asymmetric. That is, asymmetric on the positive side, meaning, in our view, there is much more upside than downside. There is probably more volatility to come, but overall our view is that most of it is fully represented in market pricing.

Keeping an Eye on Inflation

I reiterate that we would be wary of potential inflation in the United States over the long term, at least more so than the market seems to be pricing in. Because of that, we are leaning toward being a bit shorter duration in most of our strategies and portfolios generally. While we will monitor fundamentals as we go forward, that is our current bias.

Finally, in our view, opportunities do continue to present themselves over the short-to-intermediate term in fixed income; longer term, we are cognizant that there could well be some rate risk down the line driven by inflation.

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