In Store for Bond Investors, More Punch or a Shock?

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Disappointing data has caused investors to become complacent about the risk of rising rates.

"I'm the fellow who takes away the punch bowl just when the party is getting good."

— Former Fed Chairman William McChesney Martin

EXECUTIVE SUMMARY

- Investors have become complacent about the risk of rising U.S. interest rates due partly to a weather-related slowdown in the economy.
- We believe that expectations for monetary policy could be altered by a pick-up in growth and inflation over the course of this year.
- We worry that the Fed's move from *quantitative* to *qualitative* forward guidance will add to market volatility by increasing uncertainty about the future path of interest rates.
- We continue to advocate having exposure to U.S. investment grade and high yield corporate bonds given stable to improving fundamentals.
- Although geopolitical risks are clouding the near term outlook, valuations in the emerging market debt space are more attractive than they were a year ago.

THE SHOCK NO ONE IS TALKING ABOUT

Disappointing U.S. economic data at the start of 2014 has caused investors to become complacent about the risk of rising long-term U.S. interest rates. Indeed, after peaking just above 3.0% in December 2013, U.S. 10-year Treasury yields have settled back in around 2.75% as of the end of March. Our view is that this may change in the spring as the weather-related drag on the U.S. economy fades and production rebounds following the build-up of business inventories in second half of 2013.

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The Fed's decision to move ahead with tapering its quantitative easing program (QE) at its March 18/19 policy meeting suggests policymakers share our view of the economy. Investors currently expect the Fed to end QE before year-end and begin increasing short-term interest rates by the middle of 2015. We believe expectations for monetary policy could be altered by a pick-up in growth and inflation over the course of this year.

Rising inflation expectations could also contribute to volatility.

Consequently, we see the risk of another spike in long-term Treasury yields similar to what occurred last spring when the Fed first contemplated tapering QE. We also worry that the Fed's move away from *quantitative* forward guidance on the labor market and toward *qualitative* guidance on broader economic and financial conditions will add to market volatility by increasing uncertainty about the future path of interest rates.

Fixed income sectors with large retail investor bases –such as emerging market debt and high yield bonds– are more vulnerable to this volatility given the risk of bond fund outflows. However, we believe that stable to improving corporate fundamentals will continue to be supportive of investment grade bonds and the high yield sector, while valuations in the emerging market space have become more attractive since last spring. Thus, we still advocate having exposure to these sectors of the fixed income markets.

WHEN TO TAKE AWAY THE PUNCH BOWL

According to the Federal Reserve Act, the central bank should seek to "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates."[1] The Fed has interpreted maximum employment as an unemployment rate between 5.2% and 5.6% and price stability as inflation of close to 2% as measured by the personal consumption expenditures (PCE) deflator.[2]

The Fed has made significant progress on meeting its maximum employment goal. Since January 2010, the economy has added more than 8.2 million jobs and the unemployment rate has fallen three percentage points to 6.7%. This prompted the U.S. central bank to abandon its quantitative 6.5% threshold on the unemployment rate at its March policy meeting in favor of more qualitative guidance on the labor market, inflation expectations, and financial developments.[3] The Fed originally adopted its unemployment threshold in December 2012 to provide the market with greater clarity about when the central bank might begin raising its policy rate. Looking ahead, we worry that the lack of explicit objectives will create greater uncertainty about the future path of interest rates and thus add to Treasury market volatility.

Rising inflation expectations could also contribute to volatility. Up to now, the Fed has struggled to meet its longer term inflation goal with the PCE deflator running just below 1%. This is probably the main reason why the U.S. central bank is not contemplating rate hikes today, despite the drop in the unemployment rate.

Yet, some of the temporary factors holding down inflation in 2013 are likely to reverse this year. For example, patent expirations caused the pharmaceutical products category to decline on a year-on-year for the first time in more than forty years. Second, we are beginning to see tentative signs that some measures of wage growth have not only bottomed, but are accelerating. Indeed, average

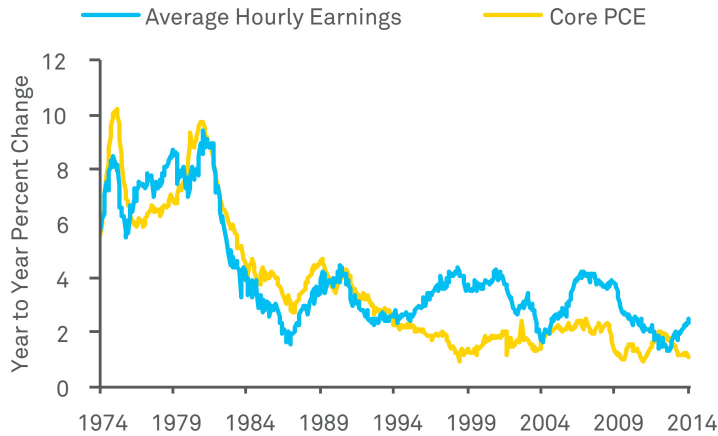
1 http://www.federalreserve.gov/aboutthefed/section2a.htm

2 Economic Projections of the Federal Reserve Board Members and Federal Reserve Bank Presidents, March 2014.

3 http://www.federalreserve.gov/newsevents/press/monetary/20140319a.htm

hourly earnings (AHE) growth troughed at 1.5% year-to-year in October 2012, but has increased to 2.1% as of March 2014. This series has historically had an 80% correlation with core inflation excluding food and energy with a two month lead time.

Figure 1: Average Hourly Earnings Point to a Pick-Up in Core Inflation

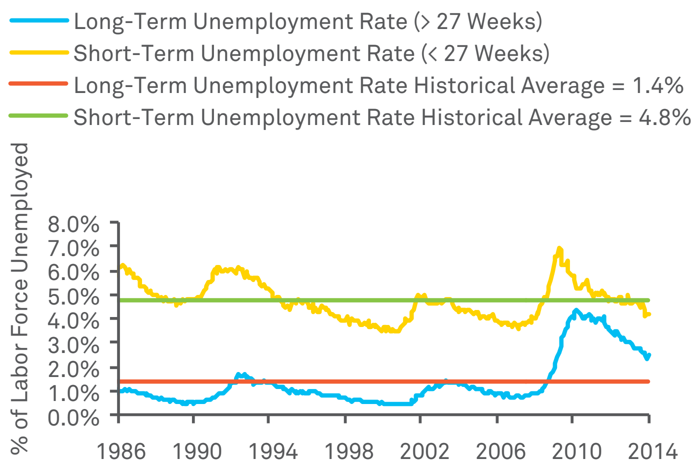


Source: The U.S. Bureau of Labor Statistics (BLS) as of March 31, 2014.

Recent research supports our case that wage growth and inflation may be poised to accelerate.

Recent research from the New York Fed and economist Robert Gordon supports our case that wage growth and inflation may be poised to accelerate.[4] They found that short-term unemployment (26 weeks or less) is a more important driver of wage growth and underlying inflation than long-term unemployment (27 weeks or more).[5] The unemployment rate for those out of work for 26 weeks or less stood at 4.3% in March compared to its historical average of closer to 4.9% suggesting there is less slack in the labor market than the official U-3 unemployment rate would imply.

Figure 2: Less Slack in the Labor Market than Official Figures Suggest



Source: The U.S. Bureau of Labor Statistics (BLS) as of March 31, 2014.

4 Robert J. Gordon. "The Phillips Curve Is Alive and Well: Inflation and the NAIRU During the Slow Recovery." Working Paper 19390. National Bureau of Economic Research. August 2013.

5 http://libertystreeteconomics.newyorkfed.org/2014/02/the-long-and-short-of-it-the-impact-of-unemployment-duration-on-compensation-growth-.html

As the year progresses, our view is that the combination of the end of the temporary factors suppressing inflation and modestly rising wage growth will lead PCE inflation to stabilize and begin to increase modestly. This may force the Fed to acknowledge that the economy may be operating much closer to its long-run potential than they previously thought which may alter investor expectations for monetary policy.

There are many ways to think about financial stability.

FINANCIAL STABILITY CONCERNS AT THE FED

Another factor that could increase market volatility is concern about financial stability at the Fed. After being blamed for inflating two asset bubbles in less than a decade, the Fed is now sensitive to fueling a third in the fixed income markets given their massive intervention in the U.S. Treasury market. In a recent speech, Fed Governor Jeremy Stein explicitly made the case for incorporating financial stability into the monetary policy framework. He argues, "monetary policy should be less accommodative—by which I mean that it should be willing to tolerate a larger forecast shortfall of the path of the unemployment rate from its full-employment level—when estimates of risk premiums in the bond market are abnormally low."[6]

There are many ways to think about financial stability. Some of the recent research suggests that the focus should be on financial leverage.[7] Yet, leverage can be difficult to measure and is better addressed through financial regulation. Instead, Governor Stein advocates a capital-markets centric view of financial stability. Specifically, he believes the Fed should track **1)** the term premium, which is the expected excess return on longer-term Treasury bonds relative to short-term bills, and, **2)** the credit risk premium, which is the expected excess return on bonds with credit risk (e.g., corporate bonds, or asset-backed securities) relative to Treasury securities.

Stein fears that when the Fed begins to increase interest rates investors will exit the fixed income markets en masse and the resulting shock will undo any of the benefits of the prior decline in credit spreads over the past few years. In fact, he finds that an increase of just 50 basis points what he calls the excess bond premium (credit spreads minus an estimate of the expected default losses on bonds) in a single quarter is associated with a two percentage point slowing of GDP growth over the next four quarters. By contrast, he says that declines in the term premium have no discernible effect at all on economic activity.

While Governor Stein acknowledges that the relationship between the excess bond premium and economic slowdowns may not be causal, he argues it is plausible that wider credit spreads could lead to reduced supply of credit and thus a slower pace of economic activity. Therefore, he believes the Fed would be warranted in using monetary policy to prevent credit markets from becoming overheated.

Although Mr. Stein is scheduled to leave the Fed at the end of May to return to his teaching position at Harvard, his views are shared by other members of the Board of Governors and regional Fed Presidents. The one notable exception is Fed Chair Janet Yellen who has acknowledged the Fed's need to detect and track asset bubbles when they are forming, but has argued that macroprudential supervision and regulation should be the main line of defense. During her confirmation hearings in the Senate,

6 Jeremy Stein. "Incorporating Financial Stability Considerations into a Monetary Policy Framework" The International Monetary Policy Forum. Washington, D.C. March 21, 2014.

7 Michael Woodford. "Inflation Targeting and Financial Stability." Leaving the Board NBER Working Paper Series 17967. Cambridge, Mass. National Bureau of Economic Research, April 2012.

Ms. Yellen said, “I would not rule out using monetary policy as a tool to address asset price misalignments. But because it’s a blunt tool, and because Congress has asked us to use those tools to achieve the goals of maximum employment and price stability –which are very important goals in their own right– I would like to see monetary policy first and foremost directed toward achieving those goals.”[8]

The question is whether Ms. Yellen would override the majority at the Fed on issues of financial stability or whether she would be more of a consensus builder. Our view is the latter. As a result, we expect to hear more from the Fed on financial stability over the coming year. Nevertheless, we believe such concerns will take a back seat to the Fed’s full employment and price stability mandate, especially at a time when it is little sign of an asset bubble in the broader fixed income markets.

The Fed has already noted that monetary policy is not on a “preset course.”

Figure 3: Fed Voter Views on Using Monetary Policy to Address Financial Stability

Supporters	Detractors	Uncertain
Stanley Fisher, Vice Chair Nominee	**Janet L. Yellen,** Board of Governors, Chair	**Lael Brainard,** Board of Governors, Nominee
Jeremy C. Stein, Board of Governors	**William C. Dudley,** New York	
Jerome H. Powell, Board of Governors		
Daniel K. Tarullo, Board of Governors		
Charles I. Plosser, Philadelphia		
Richard W. Fisher, Dallas		
Narayana Kocherlakota, Minneapolis		
Loretta J. Mester, Cleveland		

Source: Standish as of April 3, 2014.

DÉJÀ VU ALL OVER AGAIN

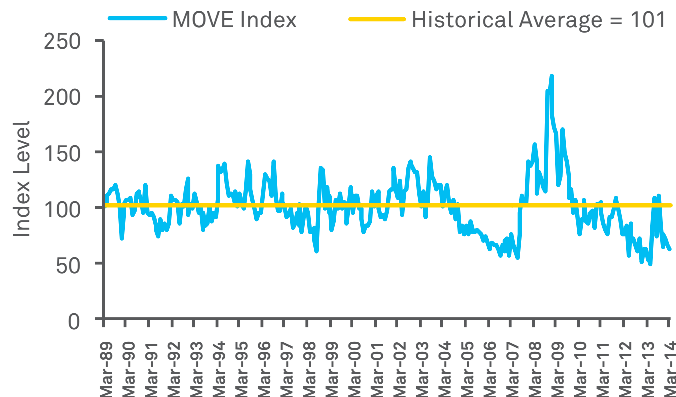
Volatility in fixed income markets is back down to where it was before the Fed began discussing the tapering QE back in May 2013. The MOVE (Merrill Option Volatility Estimate) Index, which measures the market expectation for future volatility in the Treasury market, currently stands well below its historical average. We expect this to change as the weather-related drag on the U.S. economy begins to fade and inflation gradually begins to pick-up, altering expectations for monetary policy. Indeed, the Fed has already noted that monetary policy is not on a “preset course.”[9]

8 Janet L. Yellen. Senate Confirmation Hearings Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate. Washington, D.C. November 14, 2013.

9 http://www.federalreserve.gov/newsevents/press/monetary/20140319a.htm

In the past, rising interest spreads, by themselves, have not tended to result in wider spreads in U.S. credit markets.

Figure 4: Fixed Income Volatility has Fallen Back Near Pre-Taper Lows



Source: Bank of America Merrill Lynch as of March 31, 2014.

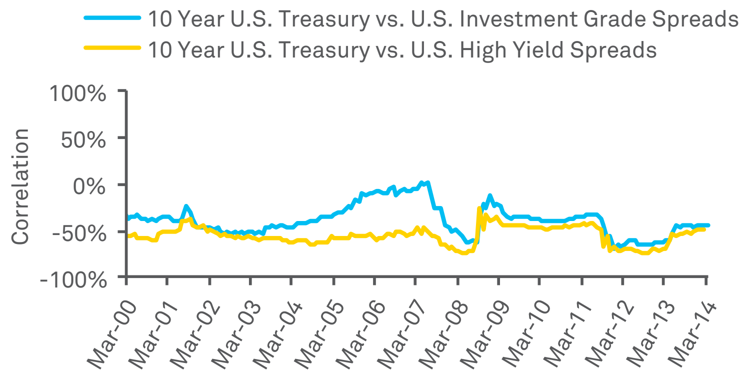
Our models of the Treasury market suggest valuations remain rich, particularly at the long-end of the Treasury curve. Yet, the recent sell-off in the short-end of the Treasury market and the flattening of the yield curve may be overdone in the near-term since Fed rate hikes are likely at least nine months to a year away. Historically, 2-year Treasury yields have led hikes in the federal funds rate by an average of three months.

Looking at other sectors of the fixed income markets, U.S. corporate bonds appear fairly valued. Historically, investment grade corporate and high yield bond spreads have been inversely correlated with movements in 10-year Treasury yields. In other words, when Treasury yields rise, spreads decline. This is primarily due to the fact that rising interest rates tend to be associated with improving economic fundamentals. We expect this time to be no different given steady corporate profitability, low default rates, and easy borrowing conditions.

In the past, rising interest rates, by themselves, have not tended to result in wider spreads in U.S. credit markets. Rather, it is typically deteriorating economic fundamentals that drive spreads wider at the tail end of the business cycle. But, as we look at the U.S. economy today, there are few signs of the characteristic imbalances that precede recessions. In fact, the U.S. continues to make progress on reducing the imbalances from the last economic cycle in the housing, consumer and government sectors.

Thus, despite our forecast for higher U.S. Treasury yields, we still believe credit spreads can hold in relatively well based on our expectation for a sustained U.S. economic recovery. We would liken the upcoming period to the Fed tightening cycles in 1994 or 2001 during which spreads in investment grade and high yield tightened after an initial adjustment to the change in the outlook for Fed policy. Should credit spreads come under pressure due to spike in Treasury market volatility, we would potentially view that as an opportunity to increase exposure.

Figure 5: U.S. Corporate Spreads Tend to Tighten When Interest Rates Rise (Correlation Analysis 36-month rolling)



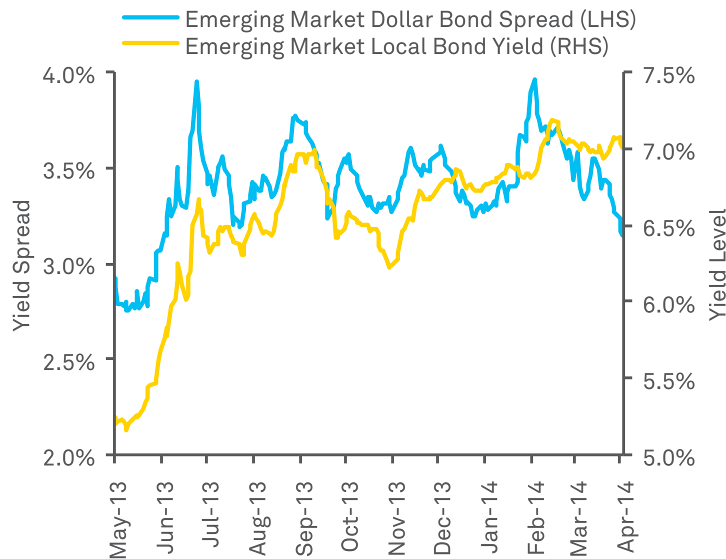
Source: Standish as of March 31, 2014.

Our view is that stronger growth in the U.S. and other developed markets will gradually filter through to emerging markets.

No sector of the fixed income market has been more battered by changing expectations for Fed policy than emerging market (EM) dollar denominated and local currency debt. EM dollar debt spreads increased from 290 basis points in April 2013 to 390 basis points in January 2014 before rallying back. Simultaneously, EM local currency yields increased from 5.23% to 7.20%. As a result, the EM asset class, particularly EM local debt, looks more attractive from a valuation perspective than it did a year ago. Not surprisingly, institutional money has started to flow back in and support the asset class.

Looking ahead, the outlook for emerging markets is clouded by slowing economic growth in China, a political corruption scandal in Turkey, and geopolitical uncertainty in the Russia and the Ukraine. Our view is that stronger growth in the United States and other developed markets will gradually filter through to emerging markets later this year, prompting investors to take a second look. Yet, it is important to be selective and avoid countries with structural weaknesses, such as Turkey. Instead, we prefer to focus on those countries that have been unjustly painted with the same brush, like Colombia or Mexico.

Figure 6: Emerging Market Local Debt Valuations Look Attractive



Source: JP Morgan as of April 3, 2014.

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