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Fixed Income: A Credit Conundrum

July 2017

In the middle of June, the Federal Reserve increased short-term interest rates for the third time in 6 months, with the benchmark Fed Funds rate increasing to a target range of 1%-1.25%. Although expected, credit markets didn't react the way the Fed had anticipated.

There appears to be a growing conundrum amidst Fed Governors as to the appropriate course of action from here. On the one hand, all but one Fed Governor voted in favor of the 0.25% increase in the Fed Funds rate in June. The one dissenting voter – Neel Kashkari, the President of the Federal Reserve Bank of Minneapolis (and a high school classmate of mine) – argued recent data on inflation didn't support further monetary tightening at this time. He favors a "wait and see" approach. However, since the rate hike, more dissenting voices are coming out of the Fed woodwork based on softening U.S. economic data and the Fed's inability to achieve its 2% inflation target.

Meanwhile, credit markets have had their own view. The Fed's monetary power rests in the ability to affect short-term interest rates (essentially, what banks charge each other for short-term loans). However, they don't have the ability (aside from massive bond-buying or selling programs), to determine the level of long-term interest rates which typically signals the confidence bond market participants have in longer-term economic growth and inflation expectations.

During the second quarter, rates generally drifted lower. On March 31st, the 10-Year Treasury bond yielded 2.41%. By the end of the second quarter (and after the rate hike), the 10-Year yielded only 2.3%. And this after seeing lows of 2.14% as recently as early June. Clearly the bond market and the Fed are not on the same page.

The question is why? We believe the answer is two-fold: First, through the use of unprecedented loose monetary policy beginning during the Great Recession in 2008, and the Fed's unwillingness to normalize interest rates sooner, the Fed has put itself between a rock and a hard place. They would like to see interest rates rise as a way of providing themselves future monetary ammunition against an economic recession. At the same time, the U.S. bond market (the deepest and most liquid capital market on Earth), is saying the Fed's fears of an overheating economy are unfounded.

Second, the Fed has two stated policy goals: full employment and 2% inflation. Goal #1 has been accomplished (although subject to some debate based on the chronic underemployed in our economy). The second goal hasn't really come close: instead, we've been hovering around 1.6% for the past couple of years.

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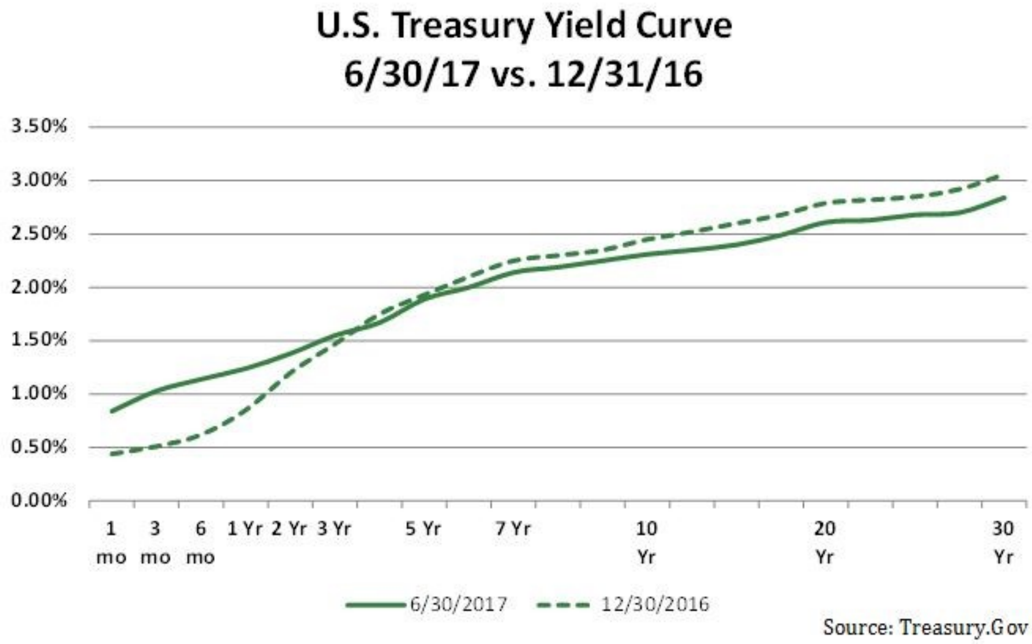

As a result, investors continue their unabated search for yield and the term structure of interest rates (the "yield curve") is flattening, meaning the difference between yields on short-term debt and long-term debt continue to shrink. Historically, an inversion of the yield curve (i.e., short-term interest rates are higher than long-term interest rates), has been perfectly correlated with the onset of a recession. In other words, the bond market isn't buying the Fed's stated reasons for increasing short-term rates and continues to bid up the prices of long-term debt (and higher yields). They may also be signaling an impending slowdown in the U.S. economy.

Jay Skaalen's recent article titled "Why Should I Care About the Yield Curve?" discussed the unique dynamics of the yield curve and the implications for U.S. credit markets and the broader economy. We've also discussed our intense focus on interest rates and inflation in today's U.S equity valuations over the past few quarters.

In short, the U.S. bond market is telling us things are not as rosy as the Fed would like us to think. This lends even greater importance to caution in the bond and equity markets. We continue to favor high-quality debt with intermediate-term maturities and a more neutral positioning in U.S. stocks.