ON OUR MINDS

# Up, Up and Away in My Bond Balloon

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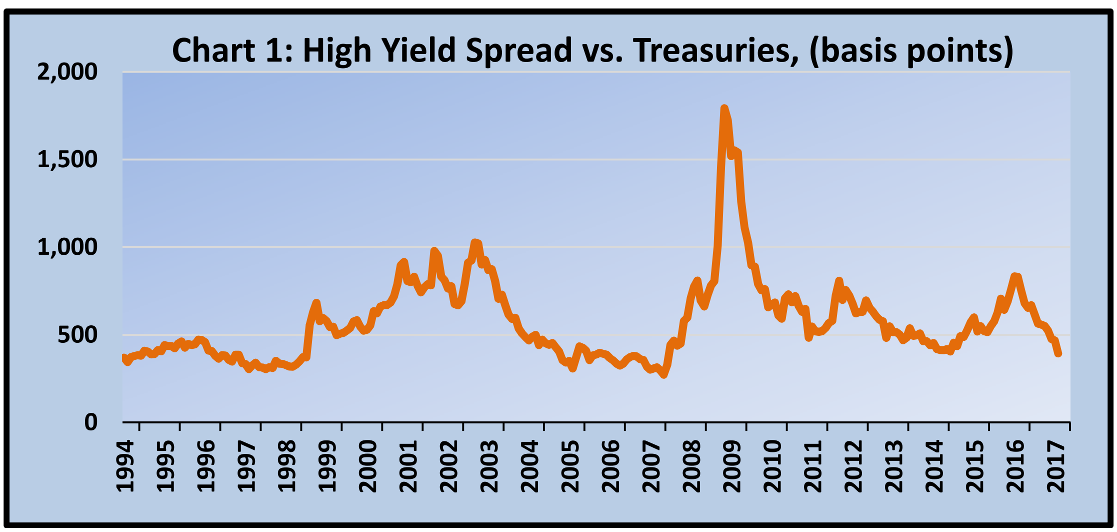
The Federal Reserve is almost certain to raise its benchmark interest rate by 0.25% this week, to a range of 0.75% to 1.00%. After months of telling investors that the pace of interest rate hikes would be exceptionally slow, the Fed now seems to be a bit more impatient. Six months ago, investors had collectively figured on one rate hike this year; by December, the consensus had risen to two hikes, and now the markets anticipate three.[1] Looking ahead to next year, investors are still expecting only two hikes, but we could get as many as four. The impact of these shifts in perception is not trivial: Investors' collective expectation for the year-end 2018 fed funds rate will have jumped from 1.50% to 2.25% in just the past three months.

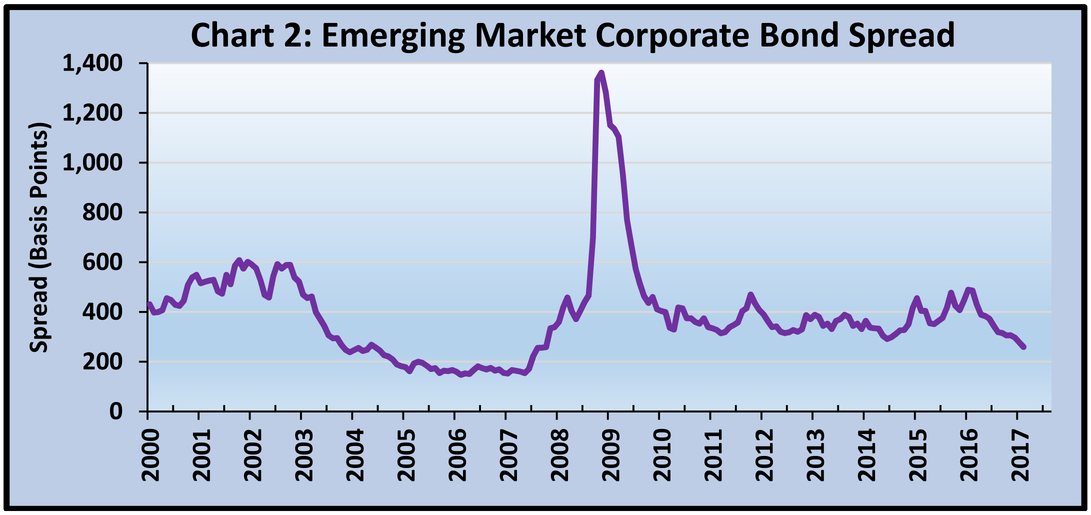
It's not surprising that short-term interest rates are starting to climb, nor that the pace may be picking up some momentum. Yet the bond market has been calm and resilient. Longer-term interest rates are almost exactly where they were in December, and not far from their historic lows of last summer, when the 10-year Treasury yield bottomed at 1.36%.

Investors are equally sanguine about credit risk. Corporate balance sheets are strong and improving; the yields on A-rated corporate bonds are now less than 50 basis points (0.5%) higher than those of comparable Treasury bonds. Even low-quality ("junk") corporate bonds and emerging market debt yields are now close to their bull market extremes and a long way from the levels that often mark the bottom of recessions (Charts 1 and 2).




Source: Shenkman Capital Management Inc.

[1] The most accurate way of determining what the investment community collectively expects is via analysis of prices for futures contracts on Treasury debt of various maturities.




Source: BofA Merrill Lynch, Federal Reserve Bank of St. Louis

Faced with high bond prices, tight credit spreads, and a more hawkish Fed, some prominent Wall Street strategists think that bond prices are now in a bubble that is about to burst, and they have advised their clients to reduce their bond holdings sharply. One of our local competitors recently suggested that clients reduce fixed income allocations in their portfolios from 40% to 15%, with a corresponding increase in equity allocations.

While it's hard to argue that bonds are cheap (or even fairly priced), there are still plenty of reasons to maintain fixed income allocations reasonably close to long-term target levels.[2] We think several factors will continue to exert downward pressure on bond yields.

First, bonds act as counterweights to stocks. Equity markets today reflect optimism that President Trump will get most or all of his economic agenda through Congress: corporate tax reform, deregulation, and infrastructure investment. As many Presidents before him learned, bending Congress to his will is no easy task, and it's possible that a substantial portion of his agenda will not be enacted. If so, bonds will cushion the inevitable stock market disappointment.

Second, investors have already given the Fed their blessings, in the form of market-driven securities prices. While the Fed has done nothing since December's quarter-point rate hike, the stock market has risen about 7% and the dollar has slipped about 2% against other currencies. Together, these market movements have had the same stimulative effect on the economy as if the Fed had cut rates by 0.5%, according to calculations by Morgan Stanley.[3] Raising rates more quickly, in this reading, is simply a way to offset market exuberance.

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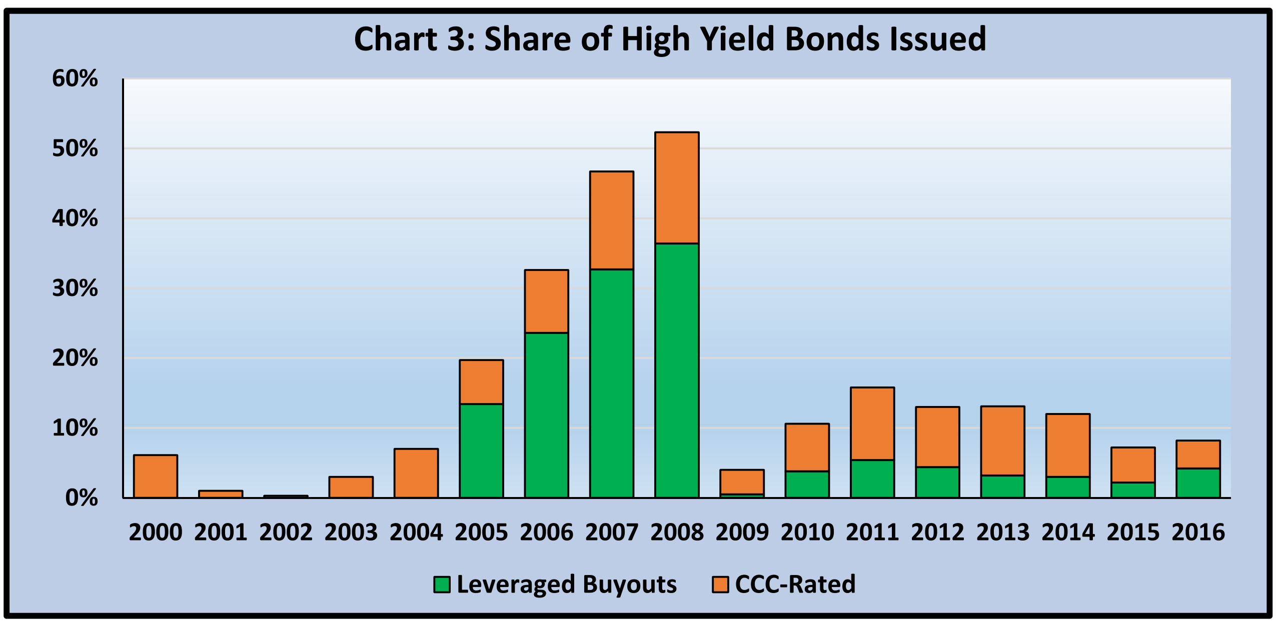
[2] In January, we slightly reduced our tactical fixed income allocations to 6.5% underweight; in our Growth with Income strategy, that would represent an allocation of 34% to bonds relative to a 37% long-term target. Since we published that tactical allocation (See "The Long, Strange Trip Ahead," January 20, 2017), equities have outperformed bonds, so clients' fixed income allocations have drifted slightly lower.

[3] Ellen Zentner et al., "FOMC Preview: A March Hike & Its Message," research note for Morgan Stanley clients, March 8, 2017. Frustratingly, the report does not show or explain the underlying calculations that led the authors to their conclusion.

Indeed, it seems that the Fed and the nation's financial markets have switched places, with the markets now dictating when the Fed can raise rates. Ever since the "taper tantrum" in 2014, the Fed has been highly cautious, hiking only when market-driven futures contracts imply more than a 75% probability of tightening. The cart has come before the horse, as the "data-driven" Fed is now using investor behavior as a key data input. Although a trio of Fed leaders[4] sealed the deal a couple of weeks ago with hawkish speeches, they didn't open their mouths until futures contracts already told them the market was ready for a more aggressive posture.

Third, there are few signs of frothy excess anywhere in today's bond markets. The most likely places to find signs of irrational exuberance would be where risk is highest: high-yield corporate securities and dollar-denominated emerging markets debt. Both market segments are behaving well, as shown above in Charts 1 and 2. While spreads are tighter than historical averages, the two charts show that they can remain at these levels for extended periods, and that they have even gone lower for substantial intervals.

In the high yield market, an examination of new bond issues is also instructive. Previous bubbles have been characterized by the market's readiness to accept large leveraged buyouts and new bottom-of-the-barrel bond issues by CCC-rated companies. In the current environment, these highest-risk new issues have been running at a small fraction of the levels seen during the late 1990s or 2007 bubble periods, as shown in Chart 3.[5]



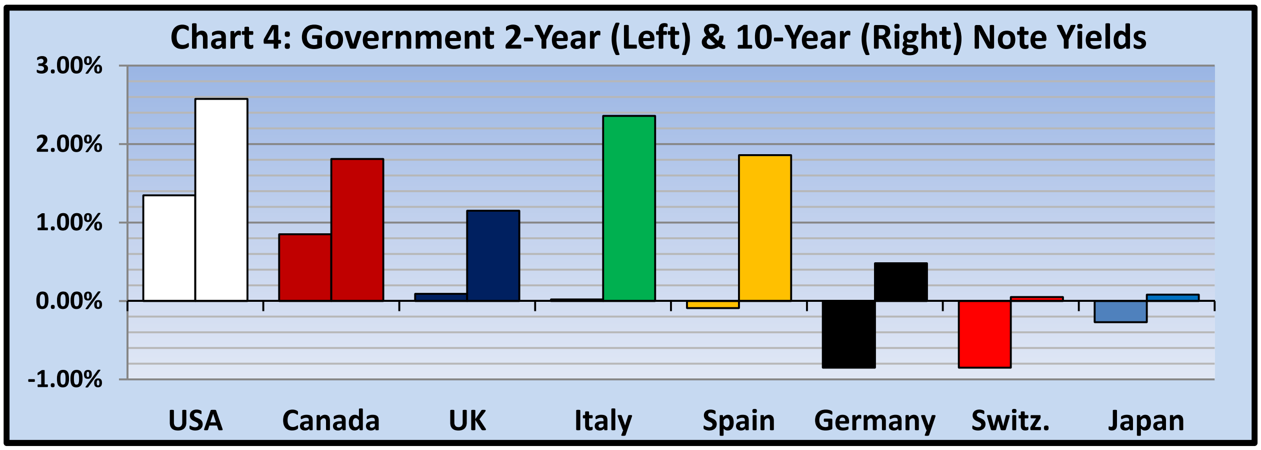

Source: Shenkman Capital Management Inc.

[4] First came William Dudley, President of the New York Fed and a permanent member of the Fed's rate-setting Open Market Committee; then Fed Governor Lael Brainard, whose speech was especially important because of her reputation as the Fed's most dovish member; and finally Fed Chair Janet Yellen herself.

[5] The same is true of initial public offerings and other indicators of froth in equity markets. Please see "Are Stock Investors Too Complacent," *On Our Minds,* March 1, 2017.

Finally, American debt is still quite cheap from a foreigner's perspective, as shown in Chart 4. None of the world's major developed economies can match the combination of safety, credit quality, and yield currently offered by U.S. Treasury debt. While the Fed is about to raise short-term interest rates, most other central banks are committed to keeping rates exceptionally low; this policy divergence may cause the dollar to resume its ascent against other currencies, magnifying the appeal of U.S. bonds.[6]




Source: FactSet

The news media have focused lately only on the strength of the U.S. economy, as measured by rising inflation, shrinking unemployment, large numbers of people returning to the labor force, decent GDP growth, accelerating profit growth, and more. The Fed sees all of that, of course, and the data collectively are driving the central bank's readiness to raise interest rates. But the Fed also sees, as perhaps the media don't, that the bond market is resilient and ready for rate hikes. Bonds are expensive, to be sure, but they may stay that way for a while longer.



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[6] I don't know if European Central Bank President Mario Draghi is a fan of American musical theater, but in the past couple of years he has been channeling Ethel Merman in Irving Berlin's *Call Me Madam*:

> *Can you use any money today?*
> *Nice new bills that we're giving away.*
> *Two million, four million, six million, eight million, ten,*
> *Take what you want, when it's gone you can come back again.*
> *Bills that haven't been printed yet, you can have them by the sack*
> *Coins that haven't been minted yet, that you never have to give back.*

Mr. Draghi persists in keeping Eurozone short-term rates below zero and in buying long-term securities to keep longer-term interest rates low as well, despite a lack of evidence that the program is actually motivating Europeans to borrow more money. Corporate borrowing and investment are driven by perceived customer demand, not by the price of money. The unintended consequence of the ECB's policy has been an exodus of capital to the U.S.