Kovitz Investment Group
Intrinsic Values®

Fixed Income Commentary

Summer 2017

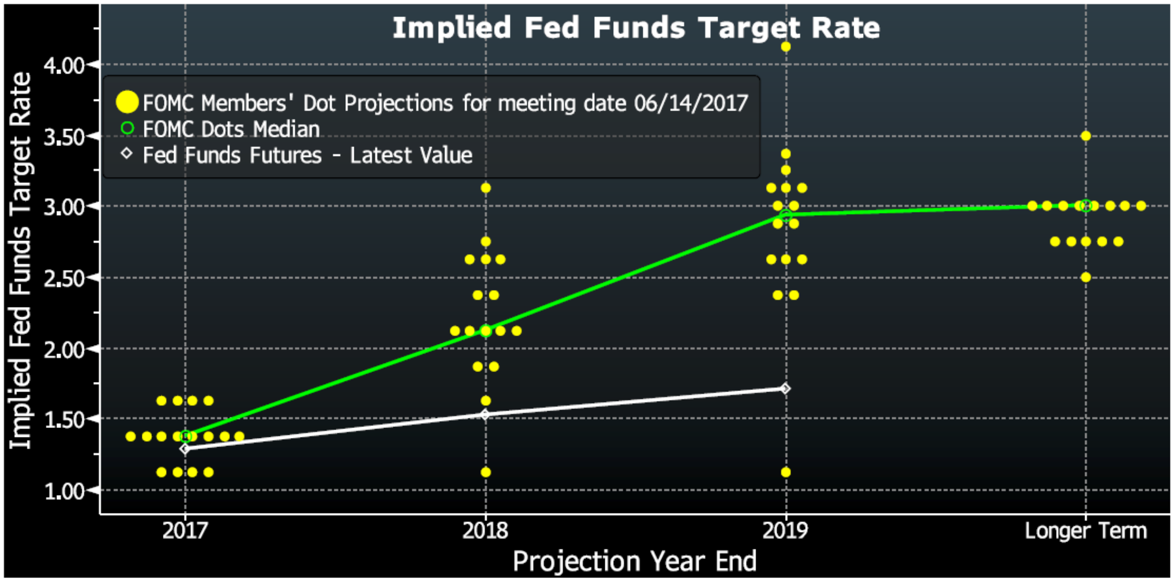
At the June Federal Reserve ("Fed") meeting, the committee once again decided to raise the federal funds target rate by 0.25% to the 1% - 1.25% range. The bump was widely expected and already priced into short-term bond yields. With inflation tapering off this quarter, down to 1.5% from almost 2% earlier this year (the Fed's target rate), the market was more concerned that the Fed would hint toward a change in policy that's more accommodative to economic growth. It did not. The Fed still expects one more federal funds rate hike this year and three more in 2018, which would increase short-term interest rates to over 2%.

The Fed also announced a concrete plan to shrink its massive $4.5 trillion balance sheet. As a monetary tool to stimulate the economy after the Great Recession, the Fed instituted three rounds of "quantitative easing." In practice, this meant that the Fed purchased Treasury bonds and agency mortgage-backed securities with the intent of bringing down longer-term interest rates. Now that the economy is on much more solid footing, the Fed plans to unwind at a slow, predictable pace by not reinvesting a set amount of bond maturities every month. Janet Yellen, the chair of the Board of Governors of the Fed, suggested that their plan would "run quietly in the background" and be as exciting as "watching paint dry." Since price stability is one of the Fed's primary objectives, their desire is to create as little disruption in the financial markets as possible.

Despite these actions, the divide between the Federal Reserve's intent and the bond market's reaction has grown wider over the last quarter. The yield on ten-year Treasury bonds peaked this year at 2.6% in mid-March and has since dropped to 2.3% as of quarter-end. Similarly, the yield on thirty-year Treasuries has fallen to 2.8% from this year's peak of 3.2%. The decrease in long-term yields in the face of rising short-term rates suggests the bond market's perception of long-term growth and inflation rates are much lower than Fed expectations.

A chart of the Fed's rate projections versus Fed Funds Futures contracts illustrates the severity by which the market is essentially calling the Fed's plan a bluff (Exhibit 1). The dots show where each voting member of the Fed thinks the federal funds rate should be at the end of each year, while the Fed Funds Futures contracts express the market's opinion. The median federal funds rates expected by the Fed at the end of 2018 and 2019 are 2.1% and 2.9%, respectively. By contrast, the market believes the fed funds rate will only be 1.5% and 1.7% on those same dates. The disconnect is so large that, if the Fed's rate path comes to fruition, one-year government bond yields in 2019 will be higher than thirty-year Treasury yields today at 2.8%.

Exhibit 1



The biggest certainty derived from the division between the Fed and market is that this bond market is filled with uncertainties. Since our overriding concern as fixed income investors is safety of principal, we feel very comfortable limiting risk in this environment. When short-term rates increase and long-term rates fall, the yield curve is said to be flattening, and bond investors are receiving incrementally less yield for investing in longer-dated maturities. By generally limiting our clients' bond portfolios to eight year maturities, we minimize the impact of these shifts in the yield curve and avoid stretching for yield when the market isn't compensating us favorably.