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Fixed Income Outlook

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Third Quarter 2017

Monetary policy for the U.S. economy will include higher short-term rates in the future. After three rate hikes in just over six months, the Federal Open Market Committee (FOMC) continues to insist that future increases will come. This foreshadowing comes despite tepid economic measures of inflation and low single-digit GDP growth. Instead, the Fed has made it clear that it is acting upon its own forecasts which expect inflation in the near term. The proactive approach is certainly viewed as decisive, but to some it is also premature.

It is important to note that the shape of the U.S. Treasury yield curve has gotten flatter as the Fed has increased short-term rates. In fact, the yield on the 10-year note is about 15 basis points lower now than it was at the beginning of the year. To some extent this flattening is a reflection of the market's opinion of the Fed's actions, suggesting that the Fed is out of step with the macroeconomic picture. If investors believed inflation was imminent, the longer end of the yield curve would move upward quickly. Traders today suggest that is not going to be the case.

Certainly, the slate of yields available from other countries' government bonds is also contributing to the low, flat yield curve. A recent spot check of global issues revealed that over a dozen countries have 5-year bonds that carry negative yields. With Europe and Japan still offering copious amounts of monetary stimulus, the United States seems at odds with the other central banks amid its withdrawal. A positive yield combined with excellent liquidity and the safety of a U.S. Government guarantee make Treasury issues a market favorite.

Fiscal policy was expected to spur the economy through more domestic-focused programs and tax cuts for corporations and individuals. So far, there has been more rhetoric than significant legislation. It appears that this administration will only continue the already-long stretch of Congress' inability to build consensus and formulate meaningful policies that bolster growth. Monetary policy has been the only form of support for the economy since its recovery from the 2008 crisis.

Turning back to the Fed, the FOMC has made its decisions with some valid motivations. Despite lagging wage growth, the labor markets are quite strong. With the Fed's full employment mandate complete, price stability is the last item to check off its list. When wages rise, the Fed argues, inflation will accelerate toward its 2% target. This is a completely logical argument, but it's also one that hinges on the hypothetical rather than the empirical.

A more central concern for the Fed is the extended period of loose monetary policy. Keeping interest rates low for so long has most observers worried about asset bubbles. While we have not seen any bubbles yet, investor tastes have begun to shift. Low yields have prompted investors to seek higher yield and return from riskier assets that would not normally be a part of their asset allocation strategy. This skewing of investors' risk/reward tolerance could prove painful in a market reversal.

The Fed must be harboring concerns that its loose monetary policy has encouraged investors to take on more risk. By tightening policy, they hope to reduce risk-seeking behavior and restore more normal investment allocations. This change must happen gradually or the Fed risks spooking markets and upending its own efforts. The Fed has been relatively clear and consistent in its message to operate methodically and monitor progress as it moves forward.

Overall, we find that the fixed income marketplace has changed little over the past quarter. Yields have been stationary save for the short end of the curve moving up. Risk premiums, or the additional yields investors require to compensate for default risk, have moved slightly lower and remain quite low when viewed on a historical basis (lower values indicate less risk while higher values indicate more risk).

From a performance perspective the investment grade market has behaved as one would expect. Corporate bonds continue to outperform other segments while U.S. Treasury and Agency issues lag behind. Lower quality has once again trumped higher quality issues as the need for yield has sent investors further down the bond ratings ladder. Shorter-maturity securities underperformed longer-dated issues, which should not be surprising since short-term yields rose and longer-term yields largely held steady.

On a forward-looking basis, we expect the Fed to continue on its path of future rate hikes. The pace of hikes should be slow and perhaps there will be a pause for a few quarters to evaluate the efficacy of such actions. Any signs of price or wage inflation would be an affirmation for the Fed to resume its tightening. This process should be unhurried—perhaps even pedestrian in pacing. Rushing here could be a hazardous mistake.

Given the expected timeline, we continue to favor high-quality, investment-grade bonds for our clients' portfolios. We remain committed to our long-term strategy of building portfolios that provide liquidity, carry high quality ratings, and favor principal protection.