Congress Asset Management Company

Fixed Income Outlook

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There is a disconnect between the performance of the U.S. economy and the future rate hikes contemplated by the Federal Open Market Committee (FOMC). Despite low GDP growth and the lack of measurable inflation, the Fed has announced that it will continue to slow monetary policy. While unemployment remains remarkably low, our economy is not growing at a fast pace. GDP for the second quarter was a modest 3.1% and the New York branch of the Federal Reserve recently forecast third and fourth quarter GDP of 1.5% and 2.5%, respectively. These are solid figures, but far from earthshaking. The Fed's presumptive actions and orientation toward higher rates put the economy at risk of slowing beyond its already tepid pace—or worse—tipping into recession.

Historically, the FOMC has been slow to act when the economy heats up. The typical Fed response comes after a period of high growth and inflation. In this case, the Fed is reacting proactively, causing some to doubt the necessity of its actions. Given low domestic growth and struggling economies abroad (e.g., the Eurozone and Japan), the Fed's policy is following a dangerous path. Slowing the U.S. economy could also negatively impact the recovery of any economy linked to it.

The shape of the yield curve is indicative of a low-inflation environment. It is relatively flat with 10-year yields about 85 basis points higher than 2-year yields, reflecting that there is little inflation today and little expected in the future. Geopolitical concerns (e.g., North Korea, Syria, and ISIS) are also keeping rates flat as investors continue to look to U.S. Treasuries for refuge in times of crisis. The low and negative yields of some foreign sovereign issues are contributors as well, as international investors appreciate both the higher yield and liquidity of U.S. Treasuries.

The FOMC now has two levers to throw as it conducts monetary policy. In addition to the usual targeting of short-term interest rates, the Fed will be reducing the size of its balance sheet. Between 2008 and 2014, the Fed purchased U.S. Treasuries, Agencies, and Mortgage-Backed Securities with the intention of influencing longer-term interest rates. The provisional plan is for the Fed to slowly unwind these positions by decreasing the reinvestment of interest and principal payments it receives.

We do not expect this normalization of the Fed's balance sheet to have a significant impact on long-term rates. Instead, the reduction will allow the Fed the freedom to purchase securities in the future should the economy falter. Perhaps this is a hedge against its current foray of preemptive rate hikes. The Fed has capped the amount of money not reinvested, so the process will take some time—it will be a methodical and predictable decrease in security holdings spanning many years.

Turning away from monetary policy, we pivot to fiscal policy and the state of affairs in Washington. To be blunt, fiscal policy is mired in disarray. No sweeping mandates or policies have been implemented by the current administration and none appears forthcoming in the near term. With several prominent cabinet members and senior officials shuffling in and out of the White House, there seems to be more internal strife than unified leadership at the top. Given the entrenchment of both parties and their antagonistic views of each other, we have no near-term expectations of Congress enacting meaningful legislation. Our economy would be better served by an expansive fiscal policy, especially with monetary policy contracting.

Performance drivers in the fixed income markets remain unchanged because the economic environment has been slow to change. Investors are still seeking higher yields in low quality issues, squeezing credit spreads (the additional yield investors require to compensate for default risk) ever tighter. Credit has outperformed U.S. Treasury and Agency issues by greater than a two-to-one margin over the first three quarters of 2017. Returns for all sectors were positive for the third quarter despite a slight rise in interest rates over the period. Lower-quality issues continued to outperform higher-rated issues while performance across the Financials, Industrials, and Utilities sectors has been relatively uniform.

Looking ahead, we see little impetus for a large move in interest rates. We expect the Fed to make good on its plans to reduce its balance sheet and raise short-term rates. The pacing will likely be slow and prudently measured against economic data points. Our concerns regarding the Fed being too aggressive will remain firmly in place until we see signs of inflation in the economy.

We believe that our clients are best served by holding high-quality, investment-grade bonds in their portfolios. Our strategic goal is to construct portfolios that provide liquidity, carry high-quality ratings, and favor principal protection.