Bond Yields Fall As FOMC Raises Short Term Rates

Ahead of the Federal Open Market Committee (FOMC) meeting on Wednesday, bond prices rose sending bond yields lower. The yield on the 10-year Treasury note fell as low as 2.1% when inflation data came in lower than expected and retail sales in May declined to their lowest level since May 2015. The consumer price index was an annualized 1.9% last month, below the Fed's 2% target. It appears the rate move was driven by investors' fear of slower growth prospects as hard data, such as manufacturing and sales readings, have not kept up with soft data, such as consumer sentiments and surveys.

Despite the weaker data that drove yields lower, the FOMC raised the target range for the federal funds rate by another 0.25%, to 1.00%-1.25%, during their meeting. The committee cited a strengthening labor market and a stabilizing inflation rate around 2% as the basis for their decision to raise rates. The individual committee member views for future rate hikes were relatively unchanged from their March meeting. The market had widely anticipated the rate hike; according to the CME Group, the expected probability was near 99%. While this increase was expected, investors are already looking ahead for clues on the next rate hike and when the FOMC would start unwinding the Fed's large balance sheet, which now stands around $4.5 trillion.

The Fed bought trillions of dollars of mostly government bonds and mortgage-backed securities during the financial crisis through its quantitative easing (QE) programs. Through QE, the Fed was able to lower long term interest rates and increase the money supply, which can be stimulative for the economy. While the Fed has stopped this program and has not been buying more bonds to grow its assets, it has been reinvesting the principal payments it receives from these securities. Investors were interested when the process of reducing the balance sheet will begin and how this process will work. Reducing this balance sheet would increase the supply of bonds in the market and could cause yields to rise, as bond prices fall with more supply.

In the FOMC press release, the committee expressed its plans to implement this "balance sheet normalization program" this year, provided the economy evolves broadly as anticipated. So, while they plan to move forward with this normalization, they have left themselves some wiggle room in case the economic recovery stalls. Investors also got more details regarding the normalization program process. The committee stated it will reinvest only to the extent that the maturing principal payments exceed gradually rising caps. The initial cap for Treasury securities will be $6 billion per month and will increase in steps of $6 billion at three month intervals over 12 months, until it reaches $30 billion per month. The cap for mortgage-backed securities or MBS will be $4 billion, increasing by that amount each quarter until it reaches $20 billion per month. Once the normalization process is fully in force, which will take 12 months, the Federal Reserve balance sheet will be shrinking by $50 billion per month. In comparison, the Federal Reserve was adding $85 billion per month as part of its latest QE program.

With the fall in yields recently, we continue to expect yields to trend higher over the course of the year. We expected the yield on the 10-year Treasury to finish 2017 between 2.75% to 3.25%. With the recent decline in long term yields and weaker inflation numbers, we expect that we will be on the lower end of this range, with 10-year yields possibly staying below 3% for the rest of 2017. As we have seen, a rise in yields is not a straight path up and there is volatility as more economic data is received. As such, we continue to recommend diversifying within fixed income, not having too much exposure to any one risk factor such as duration, credit quality or a specific sector. We recommend being underweight duration-sensitive bonds, such as mortgages and treasuries, since the reward or yield is low relative to the risk or duration of these bonds. However, we still recommend having an allocation to these higher grade bonds as they can buffer against equity volatility.

We still recommend an overweight to credit-sensitive bonds, such as investment grade corporate bonds, high yield bonds and bank loans as an improving economy coupled with low borrowing costs can be supportive for these bonds. We do caution against too much of an overweight though, as credit spreads have narrowed and these bonds are not as attractively priced as they were in 2016. These bonds can also correlate with equities in times of equity volatility. Building a diversified fixed income portfolio is important as the Fed becomes less accommodative and the bull market for equities enters its ninth year.

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The ***Bloomberg Barclays Capital U.S. Aggregate Bond Index****, which was originally called the Lehman Aggregate Bond Index, is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government–related and corporate debt securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS and CMBS (agency and non-agency) debt securities that are rated at least Baa3 by Moody's and BBB- by S&P. Taxable municipals, including Build America bonds and a small amount of foreign bonds traded in U.S. markets are also included. Eligible bonds must have at least one year until final maturity, but in practice the index holdings has a fluctuating average life of around 8.25 years. This total return index, created in 1986 with history backfilled to January 1, 1976, is unhedged and rebalances monthly.*

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