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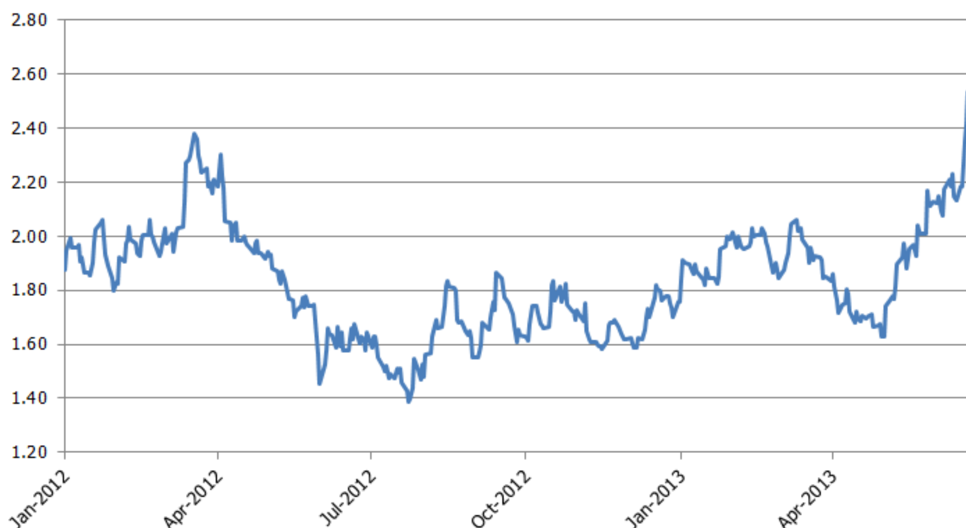
MARKET Commentary

Talk Centers on Fed Tapering

July2013

In his most recent comments in front of the U.S. Congress Joint Economic Committee (May 22nd) and Federal Open Market Committee press conference (June 19th), Chairman Bernanke began to outline the Federal Reserve's exit strategy from the extraordinary support provided under its signature Quantitative Easing (QE) program. Chairman Bernanke's confirmation of the growing suspicion surrounding the gradual reduction of Fed asset purchases leading up to a subsequent rise in the Fed Funds target rate—collectively dubbed as 'Fed tapering'—was enough to whip the market into a frenzy. Risk assets sold off and interest rates followed a one-directional path higher. While the market volatility post-announcement seemed a bit overdone in our view, investors should take notice: the FOMC's recent statement is a potential game-changing development.

Figure 1: 10-Year Treasury Yields Spike on Tapering Talk



Source: Bank of America/Merrill Lynch

In this month's market commentary, we explore the implications for future Fed tapering and how short-duration investors should position investment portfolios in the current period of uncertainty and for the future monetary policy transition.

Why Taper Now?

In athletics, 'tapering' marks the final step of a set training program; a gradual reduction of workout intensity leading up to an important athletic event. Tapering not only provides adequate time for muscles, joints and the mind to recover for optimal performance, but also prevents an athlete from overtraining—something that can prove just as detrimental to one's desired results as undertraining. As the adage goes, "tapering begins when all the hard work is already completed."

US Treasuries

As of 28-Jun

Benchmark	Yield
3 Month	0.03%
6 Month	0.09%
1 Year	0.15%
2 Year	0.36%
5 Year	1.40%
10 Year	2.49%
30 Year	3.50%

Bank of America/Merrill Lynch Indexes

31-May to 28-Jun

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.12%
1-3 Yr Municipals	-0.23%
1-3 Yr Agencies	-0.11%
0-3 Month UST	0.00%
S&P 500	-1.33%

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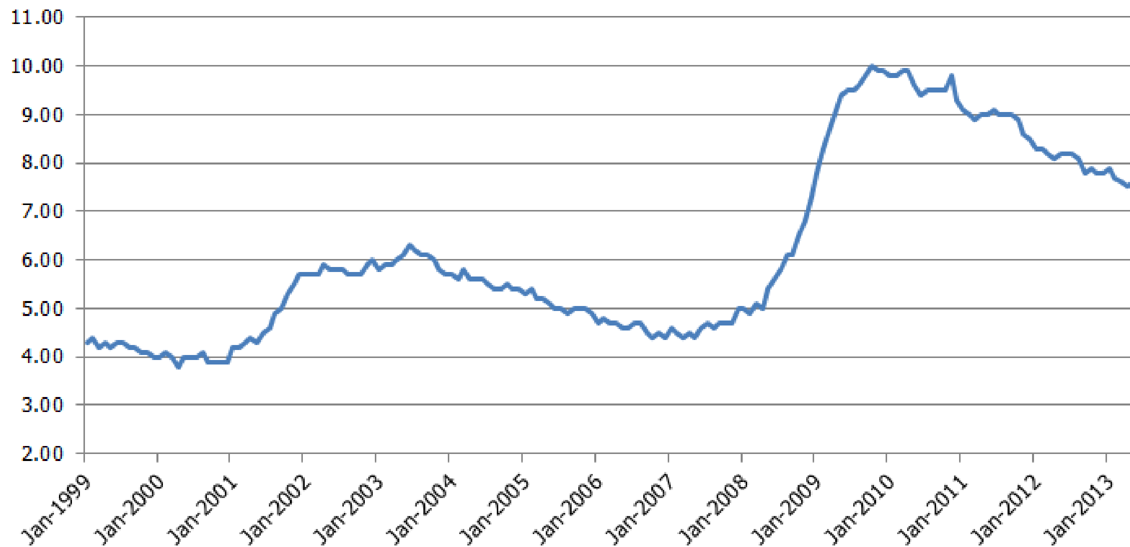
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

The ‘tapering’ moniker seems to describe well what the Fed hopes the final steps of its five-year long monetary campaign will signify for the future performance of the domestic recovery. The FOMC’s willingness to scale back monetary stimulus gradually, which many view as tightening, indicates that the Fed believes that the hard work in achieving its dual mandate of maximum employment and price stability is already complete. Tightening at this stage in the economic recovery also communicates that the Fed may see continued stimulus as a potential harm to the long-term stability of the financial system1.

Figure 2: Unemployment Rate is Slowly Declining, But Can We Believe the Numbers?



Source: Bank of America/Merrill Lynch

Chairman Bernanke has cited several encouraging economic indicators to support the FOMC’s current position. The unemployment rate has fallen from a high of 10.0% (October 2009) to 7.6%, initial jobless claims have fallen to more normalized levels, and non-farm payrolls have experienced 31 consecutive months of growth. Risk asset prices have largely recovered and, in some cases, even eclipsed pre-crisis levels. Credit markets have largely stabilized, consumer confidence continues its long-term trend higher, and the rebound in housing continues to be a bright spot.

Not Without Counterpoints

It is hard to argue that things have not improved substantially since the depths of the crisis, but opponents who question the exuberance of the recovery have their data points as well—many of which, even Chairman Bernanke agrees, are valid concerns. As the Fed has put the most emphasis on employment gains when outlining policy decisions, the most frequently cited argument against Fed tightening is the gross distortion in the labor market.

Over 9.5 million people have left the work force since 2008. This mass exodus of workers has driven the labor force participation rate to a 34 year low, painting a false picture of recent labor market gains. Payroll growth, while positive, has been well below past periods of recovery. In addition, personal income and wage growth remain stagnant, indicating that positive economic gains have not trickled down broadly to laborers.

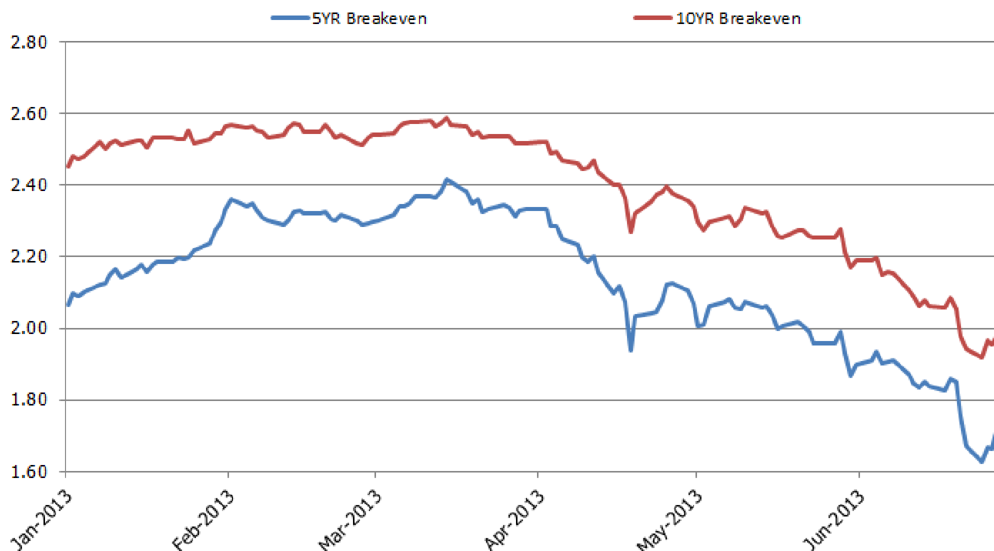
Figure 3: The Labor Force Participation is near a 30 Year Low

Source: Bank of America/Merrill Lynch

Not the least of the arguments against a rosy depiction of the economy is the dismal inflation numbers. Persistently low inflation can be both a forerunner and result of weak future economic growth, stagnant income and wages, and a decline in consumer willingness to spend. Economists generally agree that a steady inflation rate near the Fed's target of 2% is best for promoting robust economic activity.

Core CPI has been on a steady decline the past two years, and core PCE, the indicator that the Fed monitors closely, stands at only 1.1%. Inflation expectations have collapsed in recent months with five- and ten-year inflation break evens—the average inflation rate implied by comparing Treasury TIPS to nominal bonds over a given timeframe—declining 72 and 62 basis points respectively over the past quarter alone. Several Fed officials have indicated that this trend, while subject to a number of transitory factors, is worrisome.

Figure 4: Inflation Break Evens are on the Decline



Source: Bank of America/Merrill Lynch

Both sides have valid arguments in the economic debate, but given recent employment gains, the Fed seems to be gaining credibility. We don't fundamentally disagree with the FOMC's assessment of the economy nor its proposed hurdles for future policy action. Chairman Bernanke has made it very clear that any future policy actions will be data dependent. While the Fed may not have always gotten the timing right of policy actions in periods of economic stress, it has a proven track record of following through with this sole commitment (one need only observe the escalation of QE activity to support this claim). We think, however, it would be unwise for investors to expect that the current amount of stimulus will continue for an extended period. The Fed is calculated in its language, and recent comments certainly indicate its bias towards future tightening if economic conditions continue to improve.

Interest Rate Volatility and Portfolio Positioning

The market volatility surrounding Chairman Bernanke's comments does not come as a surprise to us. Risk asset prices have been a large beneficiary of Fed stimulus, and it will take the market several months to grasp the significance of the Fed's change in sentiment. By outlining the Fed's intentions, Chairman Bernanke may be attempting to prepare investors for a return to normalcy with respect to monetary policy.

As one would expect, longer-duration rates took the brunt of the beating in the market volatility post-FOMC announcement. Over the 5-day period post-FOMC announcement, the 5- and 10-year Treasury yield rose by 43 and 42 basis points, respectively. The 2-year Treasury yield, by contrast, rose by only 14 basis points. Calculating yield changes from Chairman Bernanke's congressional testimony to the Joint Economic Committee on May 22nd, the moves are even more pronounced for the longer rates: 17, 67, and 68 basis points for the 2-, 5- and 10-year Treasury yield, respectively.

Figure 5: Short-Duration Benchmarks Have Fared Better in the Recent Volatility

As of 06/30/2013

Merrill Lynch Indices	*Index Yield*	*1 Month Δ in Yield*	*Duration*	*Average Rating*	*1 Month Return*	*YTD Return*
Money Market Benchmarks						
0-3 Month U.S. Treasuries	0.03%	+0.00%	0.16	AAA	+0.00%	+0.03%
3 Month LIBOR	0.27%	+0.01%	0.25	AAA	+0.02%	+0.00%
0-12 Month U.S. Treasuries	0.13%	+0.01%	0.52	AAA	+0.01%	+0.09%
1-3 Year Benchmarks						
1-3 Year U.S. Treasuries	0.37%	+0.06%	1.89	AAA	-0.07%	+0.00%
1-3 Year U.S. Govt/Corp ≥A	0.54%	+0.10%	1.91	AAA	-0.12%	+0.04%
1-3 Year U.S. Govt/Corp ≥BBB	0.66%	+0.11%	1.91	AA1	-0.16%	+0.08%
1-3 Year U.S. Corporates ≥A	1.20%	+0.24%	1.99	A2	-0.34%	+0.21%
1-3 Year U.S. Corporates ≥BBB	1.50%	+0.27%	1.98	A3	-0.41%	+0.33%
1-5 Year Benchmarks						
1-5 Year U.S. Treasuries	0.66%	+0.15%	2.72	AAA	-0.40%	-0.54%
1-5 Year U.S. Govt/Corp ≥A	0.88%	+0.19%	2.74	AAA	-0.52%	-0.53%
1-5 Year U.S. Govt/Corp ≥BBB	1.05%	+0.21%	2.76	AA1	-0.59%	-0.50%
1-5 Year U.S. Corporates ≥A	1.70%	+0.35%	2.91	A2	-0.97%	-0.54%
1-5 Year U.S. Corporates ≥BBB	2.03%	+0.38%	2.91	A3	-1.06%	-0.36%
Mortgage Benchmarks						
0-3 WAL, Mortgages	1.67%	+0.05%	1.69	AAA	-0.34%	-0.94%
Mortgage Master	2.96%	+0.36%	4.61	AAA	-0.90%	-1.99%

Source: Bank of America/Merrill Lynch

Short-duration accounts have held up remarkably well on a comparative basis. The fundamental reason is that 2-year Treasury yields are most closely tied to short-term interest rates, like the Fed Funds rate, which have remained relatively tame in the recent interest rate volatility. Comparatively, the 5- and 10-year Treasury notes have a greater weighting to future short-term interest rates hikes priced in to their current yield, which makes them much more sensitive to future rate expectations.

The current rise in interest rates disproportionately affects fixed-income investors who have large exposures to the belly of the curve (i.e. 5-10 years). Short-duration investors should not be overly concerned. Short-duration investors who stay the course (i.e. maintain portfolio duration and credit quality at or near their benchmarks) will benefit from a higher interest rate environment and improving economic indicators that, as Chairman Bernanke has clearly noted, would necessarily precede it. Moving dramatically away from benchmark characteristics to an overly conservative investment approach could exclude investors from future benchmark gains as the current volatility subsides.

Finding attractive places to invest excess cash in this environment will not be as difficult as in past periods where short-end rates have been exceptionally low. The steepening of the front end of the curve allows investors to invest funds at attractive absolute levels that also provide favorable roll-down characteristics. Short-duration investors should view this as an opportunity. As most market participants do not expect the Fed Funds rate to rise until 2015, front-end rates should remain anchored. The anchoring of short-end rates will help to ensure that the benefits of portfolio curve roll down for 1-3 and 1-5 year portfolios will persist.

Looking Forward

Chairman Bernanke's recent comments suggest that the FOMC may indeed think that the most difficult work in ensuring its dual mandate of maximum employment and price stability is past. Expect asset purchases to begin tapering in late 2013 or early 2014 and the Fed Funds rate to remain exceptionally low until late 2014 or early 2015. This should provide short-duration investors with attractive entry points to increase the yield of their investment portfolios by taking advantage of the steepness of the front end of the yield curve while simultaneously mitigating losses associated with the general rise in longer interest rates.

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