

Chairman Powell's Fed: A slightly hawkish tilt



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- **Outcome:** *The Fed, as expected, raised interest rates by 25 basis points, to 1.75%. Chairman Powell fulfilled expectations of a more hawkish FOMC, yet quelling concerns of too hawkish a tilt. We believe that the Fed continues to risk being behind the curve in raising rates.*
- **Markets:** *The financial markets remain sceptical of rising inflation and wages. We believe stronger economic activity in Q2, along with tighter labour markets, should drive inflation and wages higher. The FOMC may move more aggressively in raising rates, leading 10-year treasury to 3.5%.*
- **How to play the current market phase:** *Active fixed income managers potentially can mitigate losses through underweighting U.S. Treasuries, diversifying into spread products that offer higher yields, and actively managing duration and yield curve exposures.*
- **US fixed income opportunities:** *We find that short-term corporate markets offer value, after recent sell off. We believe that RMBS (Residential Mortgage-Backed Securities), including both agency MBS and non-agency RMBS, potentially offer superior downside protection relative to investment grade corporates. A focus on agency MBS markets potentially provides the added benefit improving the liquidity. We also view long-term TIPS and floating rate securities as potential ways to help mitigate interest rate and inflation risk.*

The March FOMC meeting was the first under the new Fed Chairman Powell and the first meeting including projections by the new members of the Fed. What are your views on the outcome of this meeting?

K. Taubes. Chairman Powell held a successful major press conference in his first Federal Open Market Committee (FOMC) meeting, fulfilling expectations of a more hawkish FOMC, yet quelling concerns of too hawkish a tilt. While aspects of the FOMC's statement and projections support the market view of its more-dovish-than-expected bias, we believe that GDP growth and inflation trends could justify four rate increases over the year, and that the Fed continues to risk being behind the curve in raising rates. The FOMC met market expectations, revising GDP growth estimates higher over the next two years, reducing unemployment estimates, and increasing the projected federal funds rate significantly in 2019 and 2020. The projected 2020 rate of 3.4% is well above the slightly increased terminal rate¹ of 2.9%. The more dovish aspects of the meeting and projections involved the 2018 rate forecast, and their NAIRU² and inflation estimates. The median estimate for the number of rate increases in 2018 remained at three, (although only one "dot" kept that median from rising to four rate increases). Second, the FOMC reduced its estimate of NAIRU (longer-run unemployment rate) from 4.6% to 4.5%, while also projecting an unemployment rate significantly below that level in the next three years, at 3.6%. Yet these lower unemployment projections did not give rise to any marked increase in the inflation forecast. In other words, the FOMC appears to believe that wage inflation may be slower in materializing, even with employment levels well below NAIRU levels. In addition, the change in 2020 inflation estimates from 2.0% PCE inflation to 2.1% suggests that the FOMC is more comfortable with

¹ The neutral (or natural or terminal) rate of interest is the rate at which real GDP is growing at its trend rate, and inflation is stable.

² NAIRU is the non-accelerating inflation rate of unemployment, or the level of unemployment that is evident in an economy that does not cause inflation to rise.

inflation overshooting the longer run 2.0% level, implying inflation remains relatively contained.

How do you expect the fiscal expansion and trade policy will influence Fed's plans?

A. Usardi Although the Fed Statement did not explicitly mention the Fiscal package as the main reason for their growth projections upward revision, we think that FOMC members have now incorporated the effects of both Tax Cuts and at least partially of the Bipartisan Budget Act. Likely, when more details on the latter will be available, we could see some further small upside. Should the FOMC members be more concerned about the US trade policy risk? FOMC is data dependent and as of now the data support the more upbeat message conveyed: risks on the trade side are on the horizon, but so far the size of the implemented measures do not represent a significant headwind able to derail growth and inflation from their path. Yet, we may think this risk to be already in the members' minds and we could expect it to become explicitly discussed in meetings should further measures be implemented on a larger scale and call for escalated retaliation from affected counterparties. But, for now, we expect this risk to remain in the background without gaining center stage in the monetary policy discussion.

The 10 year Treasury found in 3% a critical threshold. What are your expectations for the market in the next few months? What will be the drivers?

K. Taubes. The 10-year Treasury yield continues to consolidate just below the psychological 3% level. We believe the markets remain a little bit too complacent, and points? to the March FOMC Statement that laid out the drivers for an expected breach in the 3% yield in the near term. The FOMC Statement upgraded its inflation outlook, expressing growing confidence of rising inflation. The Fed also upgraded its longer-term growth outlook, which was likely affected by easier fiscal policy from the tax bill. Finally, the Fed continues to expect the labour market will continue to tighten, which is reflected in lower unemployment rate forecasts in its March Statement of Economic Projections. The financial markets remain sceptical of rising inflation and wages. We believe stronger economic activity in Q2, along with tighter labour markets, should drive inflation and wages higher. However, should GDP growth and inflation surprise on the upside, which could be achieved in the absence of any significant trade disagreements, the FOMC may move more aggressively in raising rates. In this scenario, the 10-year could rise to 3.5%. In addition, markets may not have appreciated the potential impact on yields of global convergence of monetary policy. The ECB decision in early March to drop its pledge to increase bond buying as needed marks a slow but continuing trend toward monetary tightening. We believe that discussions over the presidency of the ECB, which should begin this summer, may further underscore that a member of core Europe, if not German, may lead to a further tightening bias. This convergence means that yield differentials could narrow, resulting in less foreign demand for U.S. assets, and hence, higher U.S. yields.

Where you expect the main sources of return for US fixed income investors will come from in the next few months?

K. Taubes. It is possible that core fixed income indices may continue to sustain modest losses as rates rise. We believe, however, that active fixed income managers potentially can mitigate losses through underweighting U.S. Treasuries, diversifying into spread products that offer higher yields, including global fixed income credit exposures, and actively managing duration and yield curve exposures.

What areas still offer attractive potential returns in the credit markets? How would you assess the liquidity risk in the market?

K. Taubes. We find that short-term corporate markets offer value, having sold off in the past few months, as corporations have repatriated offshore cash portfolios and sold corporates. In addition, in the wake of increased rates, certain investors are favouring Treasury bills over

commercial paper and short-term corporates. Overall, however, we believe that investors may want to limit downside risk in this period of stretched valuations. Even though corporate credit spreads have widened since the beginning of the year, spreads remain near all-time lows. We believe that RMBS (Residential Mortgage-Backed Securities), including both agency MBS and non-agency RMBS, potentially offer superior downside protection relative to investment grade corporates. While we believe the fundamentals for both the housing markets underpinning the RMBS sector, and for the broad economy, are strong, we think it's appropriate to broadly reduce credit exposure in light of less attractive values. In broadly diversified fixed income portfolios, a focus on agency MBS markets potentially provides the added benefit improving the liquidity. While liquidity remains relatively strong across the markets, in light of strong fundamentals, liquidity risk should be considered in any fixed income strategy.

"Given extended valuations in most corporate sectors, investors should favour structured sectors, particularly MBS."

With a multi sector perspective, what are the sectors you expect to deliver the better risk/return potential in the next few months?

K. Taubes. We believe multisector bond investors may want to be more defensive in terms of sector allocations. While we hold a constructive view of U.S. and global GDP growth, we believe that many credit sectors have fully priced in this positive news, with less focus on potential downside risks, such as the declining central bank-induced market liquidity and the potential negative impact of trade disputes. Given extended valuations in most corporate sectors, we have generally favored structured sectors, particularly MBS. Over time, structured securities, including agency MBS, exhibit more attractive risk-adjusted returns than other sectors. We also view long-term TIPS and floating rate securities as potential ways to help mitigate interest rate and inflation risk.

On the US dollar, do you see the current weakness continuing? What will be the drivers in the next few months?

S.Di Silvio. We think the current weakness of the US dollar is mostly due to cyclical factors. Historically, the US economy is leading DM economies, and the USD tends to strengthen towards DM currencies during recovery and expansion of the economic cycle, as the FED tends to precede other CBs' hiking cycles. Now we are in a phase in which the Fed is well on track in its recalibration policy, and the markets are anticipating the other CBs' moves. With the ECB this happened last year (with Euro appreciation) and with the BoJ it might start this year. We expect the USD to continue to remain on a weak trend as the introduction of the fiscal package from the Trump administration is going to weigh on the US twin deficit which is set to increase in size over the next couple of years, exerting downward pressure on the currency. On the technical side, as a consequence of increasing US yields, the cross currency basis³ of the USD has widened vs other currencies. Therefore investing in US Treasuries (on a hedged basis) is not as attractive neither for Japanese nor for European investors, having the dollar hedge become more expensive. On the valuation front, USD still looks overvalued on a trade weighted basis, although to a much lesser extent than in 2017. Finally, the negative effect on the currency caused by US policy's unpredictability must not be underestimated, on both internal and foreign affairs, which harms foreign investors' appetite towards holding USD denominated assets.

³ The cross-currency basis, is the basis spread added mainly to the U.S. dollar London Interbank Offered Rate (USD LIBOR) when the USD is funded via foreign exchange (FX) swaps using other currencies.