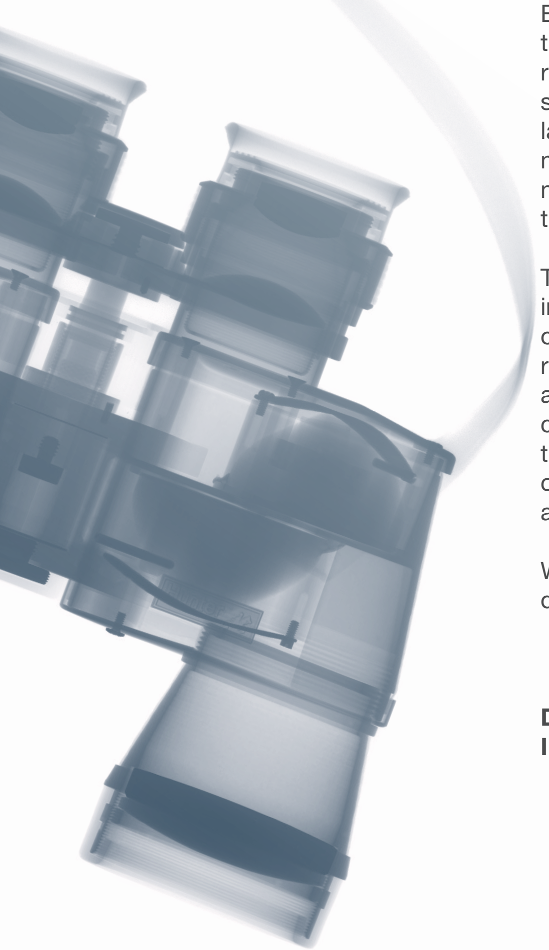
Heartwood
Investment Management

7 April 2017

Investment Insight

Weekly Insight



Fed watch: Prepare for more bond market volatility

More often than not the minutes of central bank policy meetings offer few surprises. However, it is worth paying attention to the latest US Federal Reserve (the Fed) minutes of the March meeting.

The higher level of conviction in the US economic outlook was notable, implying that the ‘dot plot’ – Fed policymakers’ interest rate forecasts for this year – will be realised. This has not been the case in recent years. Indeed, while economic activity has been softer in the first quarter, policymakers believe the influencing factors to be seasonal and therefore transitory. Rather, they view the balance of risks as being skewed towards the upside based on an economy at or near full employment, supportive financial conditions, and expectations (even though delayed) of expansionary fiscal policy.

More surprising, though, was the discussion around unwinding the Fed’s $4.2 trillion balance sheet. All other things being equal, if the US economy performs as expected and we see gradual interest rate hikes, then the Fed would consider slowing the current policy of reinvesting the proceeds of maturing bonds: around $425 billion of US treasury and mortgage-backed securities are expected to mature in 2018.

What does this mean for the market?

Based on current market pricing, bond investors are not yet entirely convinced that the Fed will tighten policy as much as it potentially suggests. The yield spread (interest rate difference) between the five-year and thirty-year maturities is at its narrowest level since 2015. Given the glacial pace at which the Fed has moved interest rates over the last year, the bond market has probably been right not to believe the Fed. However, it might be wise for investors to start listening to policymakers now. In our view, the Fed minutes suggest that policymakers want to move faster, albeit in a gradual fashion, than the bond market would like in terms of its overall ‘normalisation’ process.

The consequence of a US treasury market playing catch-up with the Fed is likely to introduce higher levels of interest rate volatility. We would also expect upward pressure on the term premium – the compensation investors receive for inflation and interest rate risk – which would result in tighter financial conditions. Higher levels of volatility and higher yields could be further accentuated in an environment where other global central banks are looking to step away from ultra-accommodative policies, such as the European Central Bank. We also have to consider that the Fed could see a regime change in early 2018, with potentially a new Chair and Vice Chair, adding to uncertainty around future policy.

We believe all of these factors continue to support our view of being wary of global duration.

David Absolon
Investment Director

Clear Thinking

Contact

To find out more about the Heartwood strategies, visit our website or contact your local representative.

Registered Head Office: No.1 Kingsway, London, WC2B 6AN | Registered in England Number: 4132340

020 7045 2600 | heartwoodgroup.co.uk | Part of the Handelsbanken Group