Bond Market Perspectives

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Fed Nerves

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Highlights

Despite recent weakness, bonds continue to discount the pace and magnitude of Fed rate hikes.

A few facets of this week's Fed meeting may reveal whether the recent pullback in bonds continues to stabilize.

Bonds continue to exhibit nervousness ahead of this week's Federal Reserve (Fed) meeting. Bond prices weakened for seven consecutive trading sessions—the longest losing streak in over one year—before closing modestly higher on Monday, September 15, 2014. The last stretch to witness such consecutive bond price declines occurred in August 2013, toward the end of the taper tantrum sell-off.

Doubts about whether the Fed would follow through on ceasing bond purchases and hold to its time frame of a mid-2015 rate hike have been a positive driver of prices all year. Recently, however, balanced comments from Fed Chair Janet Yellen and a San Francisco Fed paper that highlighted bond market complacency regarding the start of rate hikes in 2015 have pressured the bond market.

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Despite the recent pullback, bonds still remain priced for a friendly Fed. Bond futures continue to suggest a slower pace of interest rate hikes compared with Fed forecasts, and futures also reflect an expectation that the Fed will not raise interest rates as high as forecast. The bond market essentially continues to question the pace and magnitude of Fed interest rate hikes even after a 0.25% yield increase in the 10-year Treasury over a short two weeks (late August through mid-September 2014).

Whether current bond weakness continues, stabilizes, or reverses may depend on the following key factors at this week's Fed meeting:

- **Considering "considerable."** The Fed has stated it will remain on hold for a "considerable period." In the past, dropping the term "considerable" has preceded an interest rate hike by approximately six months. Should it do so now, that timing would coincide with a rate hike in March 2015—something the market is not priced for—and would likely result in lower prices and still higher yields. We expect the Fed is aware of such negative consequences and may likely err on the conservative side and keep the language in place. Please see our *Weekly Economic Commentary: Fall FOMC Watch* (September 15, 2014) for additional details.
- **An end to bond purchases.** Perhaps the most widely anticipated aspect of this week's Fed meeting is an announcement that bond purchases will end in October 2014. A delay may support prices, however, as the Fed is viewed as keeping stimulus in place for longer.

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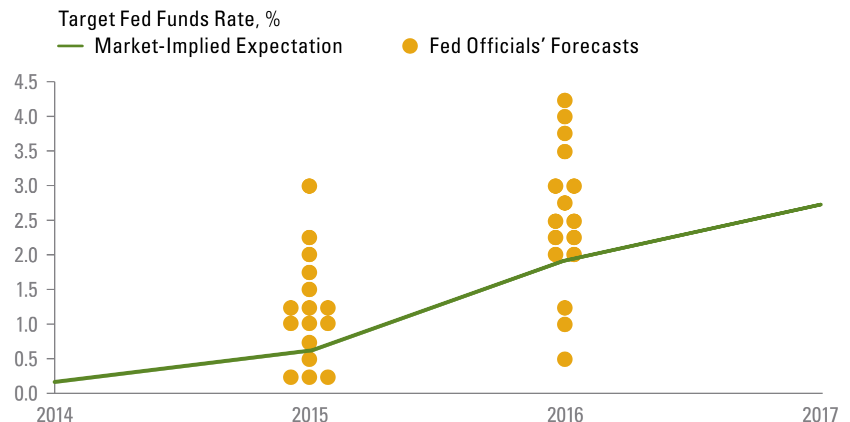
- **The "dots."** Each quarter the Fed updates its strategic projections including Fed members' forecasts for the target fed funds rate — the overnight lending rate — and plots them on a graph represented by dots. The September meeting will include new Fed forecasts for 2017, in addition to forecasts of the target fed funds rate for year-end 2015 and 2016. Should Fed forecasts reflect a quicker pace or greater magnitude of rate increases, bond prices may weaken in response. As mentioned, even after recent bond weakness, bond futures remain priced at the low end of fed fund forecasts as represented by the Fed dots [Figure 1]. The majority of the dots, representing a member's forecasts, remain above current market pricing.

1 Futures Still Indicate Rates That Are Lower Compared With Fed Forecasts

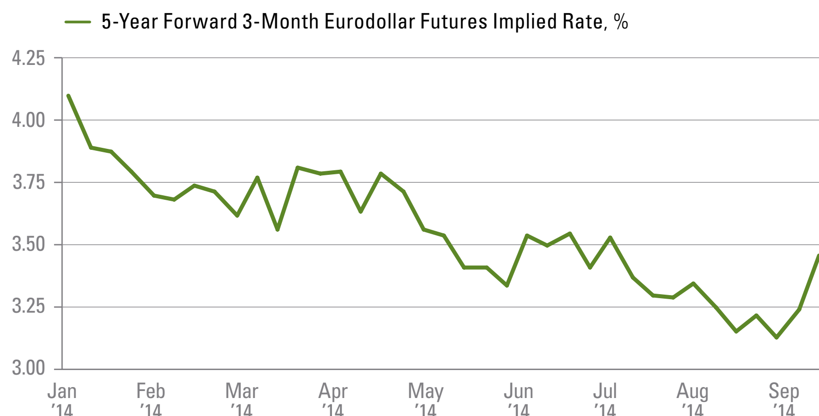


Source: LPL Financial Research, Federal Reserve, CBOT 09/15/14

- **The long-run fed funds rate:** Fed officials also produce a forecast of the long-run fed funds rate, essentially a long-term neutral rate where the Fed may stop raising interest rates. The Fed has not defined "long-run," but investors widely associate it with a five-year time frame in keeping with other key metrics followed by the Fed. A decline in how high the Fed may raise rates has been a driver of lower yields in 2014. The Fed recently revised the long-run rate lower to 3.75% from 4.00%, but longer-term futures show the bond market is expecting the Fed to stop short of its reduced long-term target [Figure 2]. The three-month Libor (the London Inter-Bank Offered Rate) tracks the overnight fed funds rate very closely and indicates where the bond market believes the Fed's neutral rate is. Fear of the Fed turning less market friendly, or hawkish, has pushed this expectation up recently, but it remains below the Fed's latest forecast of 3.75%. Reiteration of the 3.75% level could lead to additional bond weakness.

Nervousness ahead of the Fed has led to softness across the bond market over the past two weeks. No sector has been spared but shorter-term bonds are proving more resilient. Bonds remain priced benign relative to the

2 Futures Still Reflect an Expectation the Fed Will Not Raise Rates as High as Forecast



Source: LPL Financial Research, Bloomberg 09/15/14

Fed's stated path and weaker prices may persist if the Fed remains on track or sounds more hawkish.

But the Fed has surprised investors before. The Fed failed to follow through on a widely anticipated "tapering" announcement at the September 2013 meeting before announcing a reduction in bond purchases in December 2013, just as market consensus expected the Fed to hold off due to illiquid year-end conditions. An extension of bond purchases or softer language by the Fed could support bond prices.

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After a strong start to 2014, we believe bonds remain vulnerable, as pricing is not in line with Fed guidance. Although corporate bonds have been equally affected, in some cases worse, during the two-week downturn, we think they will prove more resilient from the stronger economy that may force the Fed's policy. ■

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