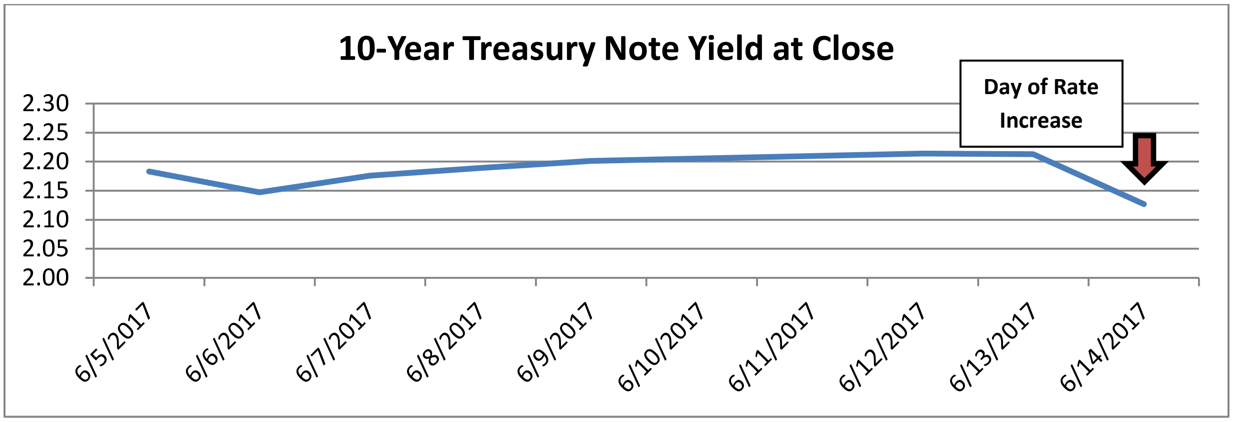
Initial Take on the Fed Rate Hike

In a widely expected move, The Federal Reserve voted to increase the Federal Funds rate from a range of 0.75% to 1% to a range of 1% to 1.25%. The vote was nearly unanimous, with only one Fed governor voting to maintain the rate. This was the third consecutive rate hike by the Fed.

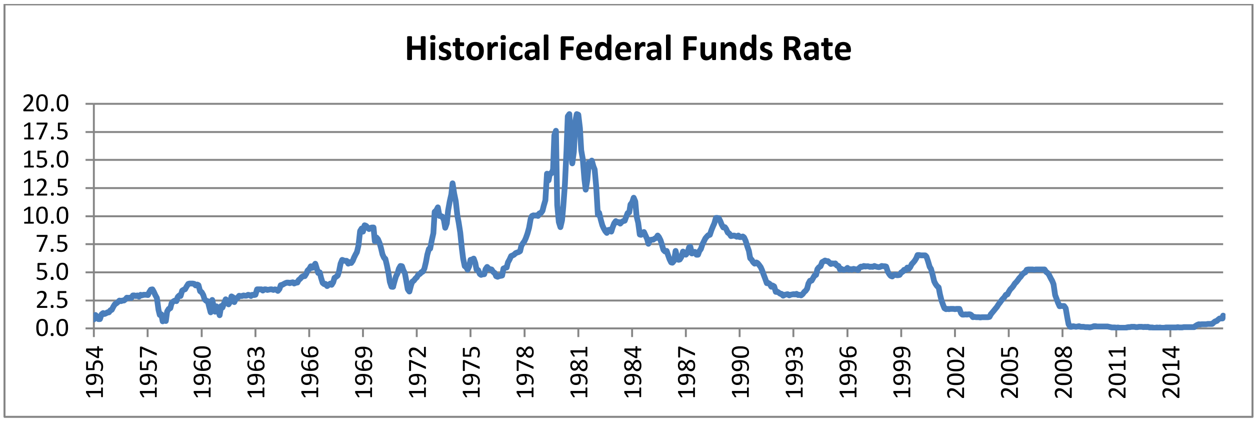
Additionally, the Fed announced plans to shrink its balance sheet.

What are the Implications of the Rate Hike?

As a generalization, bond yield (or income earned on the bond) and the fed fund rate are positively correlated. As the fed raises its rate, yield goes up as investors expect a higher return to hold the asset. In contrast, yield and bond prices are inversely correlated. In other words, if the yield goes up, the bond's price must go down. However, in this case, the 10-year Treasury note yield declined (meaning the price increased) after the announcement. Most likely, this is because the market had already accounted for the increase, and the removal of uncertainty raised investor demand.



Additionally, this yield behavior suggests the markets remain skeptical that this rate increase is a harbinger of future dramatic rate increases – although there may still be future modest increases. As the graph below indicates, the federal funds rate remains near historic lows.



What are the Implications of the Fed's Plan to Shrink Assets?

As a result of the quantitative easing programs put into effect after the market collapse in 2008, the Fed now finds itself owning $4.5 trillion in government and mortgage securities. Based on the limited information presented, it appears the Fed plans to gradually unwind its positions through maturities without buying replacement bonds. This will be an extremely gradual process taking years, as the Fed is talking about reducing at a rate of $10B a month initially combined between government and mortgage securities. This announcement matters because there has been a concern the Fed would start aggressively selling its positions. This could drive up yield – which punishes current debt holders.

What Does This Mean for My Portfolio?

In the short term, the good news is that the rate increase most likely had a positive impact on your debt exposure. Our debt fund managers within *VestAdvisor Select*® were well positioned and benefited. Since the markets had incorporated the rate hike, the yield on longer-dated debt on government declined – making the bonds more valuable. For short duration debt, the rate increase has only a nominal impact on price but translates into future higher yield.

In the long term, we would still advise caution with government and agency debt exposure – especially because there may still be near term additional rate hikes. The 10-year Treasury note at 2.13% may not cover inflation – even before adjusting for taxes. Additionally, if the fed funds rate goes up, it can have a dramatic effect on long-dated debt. For example, with a 10-year zero-coupon bond, a 25 basis point increase in yield should translate to a 2.5% decline in price – or 10X impact.

If you have any questions regarding your investment positioning, we encourage you to work with your HD Vest Advisor to establish a strategy based on your personal goals and unique financial situation.

Note: Source for quotes and guidance is FOMC statement and supplementary materials and Chair Yellen's Press Conference Opening Statement posted under Monetary Policy on www.FederalReserve.gov.