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MARKET CALLS

Fixed Income Strategy: Take The Low Road

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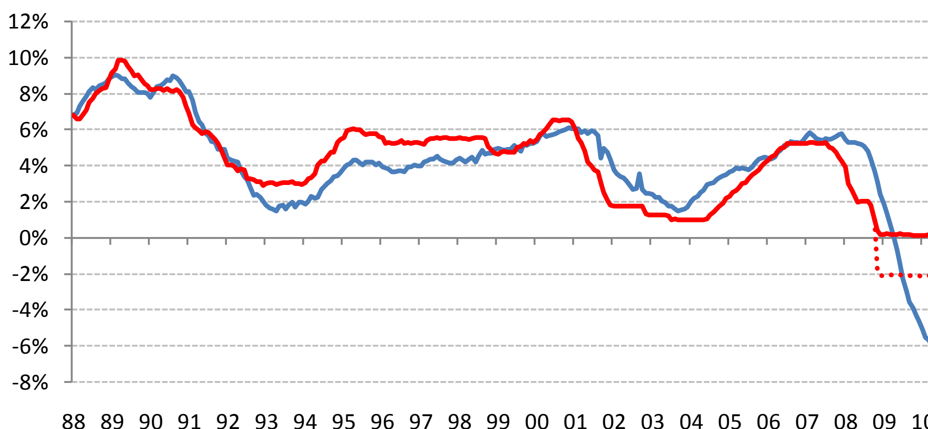
The Fed is stuck where it is this year and next: so bet on low yields and low quality.

Strategy in bonds should be based on the virtual certainty that the Fed will keep US interest rates at today's ultra-low levels until further notice -- without doubt for the rest of 2010, and highly likely for all of 2011. This means both no change in the zero funds rate target and no pro-active shrinking of the Fed's large balance sheet. As we keep saying: *no exit.*

This is a no-brainer. The Fed has made it perfectly clear that any retraction of the "extended period" of ultra-easy policy would be contingent on economic developments. *There is no feasible combination of developments that could drive a change toward tightening any time soon.* A simple rule that fits the actual funds rate for the past two decades, based on core inflation and the unemployment rate, puts the ideal rate in today's environment at negative 6.6% (please see the chart below). Even assuming that the Fed's large balance sheet makes the zero funds rate equivalent to about negative 2%, policy should be *looser*, not tighter now. Based on the fitted rule, the unemployment rate would have to fall below 7.7%, *or* core PCE inflation would have to rise above 4.3% to justify any tightening at all. A combination of the two makes a more feasible scenario,

— Rule-based funds rate — Actual .... Adjusted for balance sheet

Rule = 2.07 + 1.28 x 12-mo core PCE inflation - 1.95 x (UE - CBO natural rate)



Source: Federal Reserve, BEA, TrendMacro calculations per Rudebusch (2009)

Update to strategic view

US BONDS: Amidst false double-dip fears, the 10-year is a trading short at 3.3%. But strategically, the Fed's commitment to an "extended period" of ultra-ease means a range-bound yield with a top near 4%.

HIGH YIELD BONDS: With the Fed committed to keeping the Treasury yield capped and to lowering solvency risk throughout the economy, high yield bonds are a buy at the well above-average spread of 7%.

FED FUNDS: Don't worry about Hoenig or Plosser. There's "no exit" for the Fed. The funds rate will be zero all this year and probably all next year, and the balance sheet won't be reduced.

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but is still highly unlikely: if core inflation rises to the Fed's informal target of 2%, *then* the unemployment rate would have to fall below 8.3% to justify any tightening. It's just not going to happen this year, and it will be a reach for it to happen next year.

It's straightforward to adapt fixed income strategy to what the Fed is trying to accomplish by staying so loose for so long.

Job One: Anchor the treasury curve

Two months ago when the 10-year yield touched 4% we said it was a great entry point for longs, because we know that the Fed's explicit purpose for promising a zero funds rate for an "extended period" is to keep a lid on long rates (see "Obamacare: Do Markets Care?" March 18, 2010). Don't fight the Fed on this one. *It's happening exactly as Ben Bernanke himself planned it* in his notorious "helicopter drop" speech in November, 2002:

> So what then might the Fed do if its target interest rate, the overnight federal funds rate, fell to zero? One relatively straightforward extension of current procedures would be to…for the Fed to commit to holding the overnight rate at zero for some specified period. Because long-term interest rates represent averages of current and expected future short-term rates, plus a term premium, a commitment to keep short-term rates at zero for some time--if it were credible--would induce a decline in longer-term rates.

Now the 10-year yield is at 3.27%, driven lower in a growth-scare exacerbated by worries about Europe's debt problems. But the key purpose of the Fed's capping long rates is to promote growth -- so while the cap *explicitly* limits the upper end of yields, it *implicitly* limits the lower end, too. The result is a trading range, and we think we're near the lower end of it, with fears of a double-dip recession entirely unfounded. In fact, we're surprised it traded as far below 3.50% as it did (see "Gold is the Strongest Currency" May 6, 2010). So at today's levels, *as a trading matter*, we'd be a seller of the 10-year rather than a buyer. But *as an investment matter*, we're not afraid to extend maturities. The curve will stay anchored with a zero funds rate for a very long time.

Job Two: Lower solvency risk

That said, the Fed is making it fruitless to pay up for quality by doing everything it can to reduce solvency risk -- so why operate in Treasuries at all? A zero funds rate makes it effectively cost-free for banks to fund themselves -- at a stroke removing the incentive to fire-sell riskier balance sheet assets, and facilitating recapitalization through accumulated net interest income. This enhances solvency throughout the economy, and at the margin makes it easier for any debt issuer to fund or re-fund.

Tactically, this made high-yield bonds the buy of a life-time in December 2008 when the Fed first lowered the funds rate to zero with the junk spread

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[About us]

Recommended Reading

The Fed's Exit Strategy for Monetary Policy
By Glenn D. Rudebusch
Federal Reserve Bank of San Francisco *Economic Letter*
June 14, 2010

How California's Public Pension System Broke (and How to Fix It)
Adam B. Summers
Reason Foundation
June 2010

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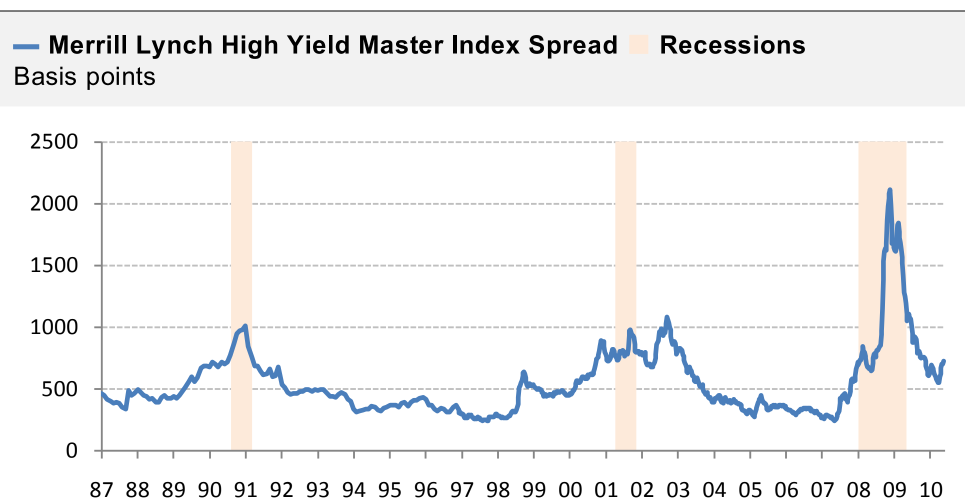
as high as 21.8%. For the record, we were three weeks early calling the top in the spread (see "It's a Recession -- Not the End of the World" November 21, 2008). Strategically, we've been positive on high-yield bonds ever since (see "Great… Now What?" August 21, 2009), and still are with the spread now down to 7.2%.

Why forgo any spread at all for the sake of quality, when the enormous flood of liquidity provided by the Fed's commitment to maintaining a zero funds rate will both mitigate default risk among high yield issuers, and drive an ongoing reach for yield that will keep spreads from widening much from here? At the same time, as the Fed keeps a lid on the Treasury curve throughout this year and next, the platform level of yields on which the spread sits won't shift adversely.

We're well aware that it's difficult to get excited about high yield bonds at a 7.2% spread when less than two years ago it was 21.8%. But that was a once-in-a-lifetime deal, and a 7.2% spread to Treasuries is extremely attractive if we are right about Fed policy and what it implies for Treasury yields and default risks. Besides, 7.0% is a considerably above-average spread. The average since 1987 is 5.9% -- and it's 4.9% if you exclude the anomalous spike in the recent credit crisis. In fact, 7.0% is high enough to be thought of as marking the low end of recessionary (please see the chart below). That makes high yield bonds a "goldilocks" investment -- the spread is high enough to be attractive, but not high enough to cause a recession -- low enough to enable funding of growth-producing investments, but not low enough to fund the kind of boom that would move the Fed off its current ultra-easy policy posture.



Source: Merrill Lynch, NBER

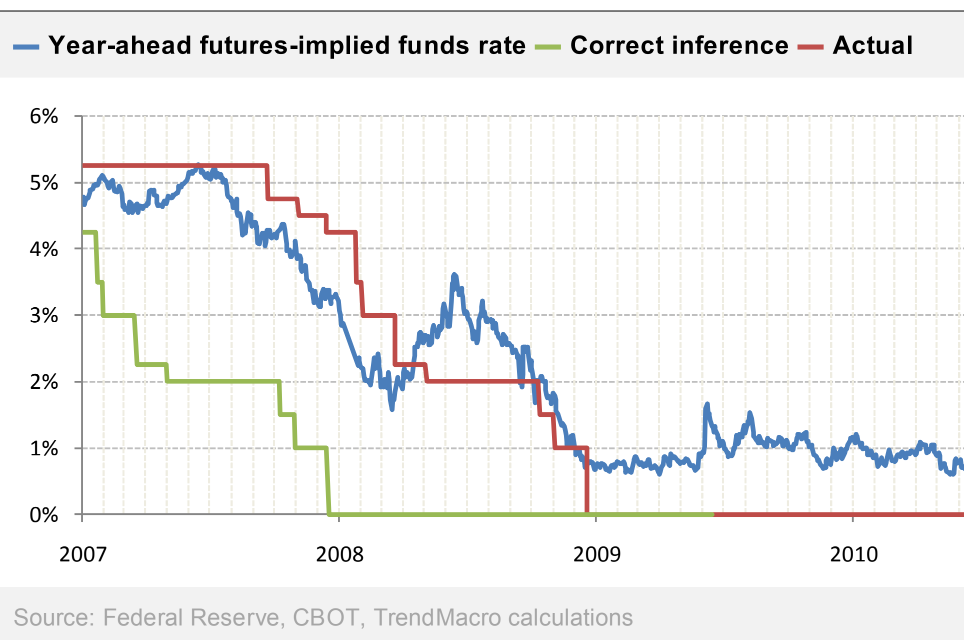
Job Three: Keep inflation expectations in check

The Fed's trickiest task is to keep inflation expectations anchored while, at the same time, running far and away the easiest monetary policy in US

history. At the same time as it portrays itself as vigilant about inflation, the Fed must be "credible" (Bernanke's word) in its commitment to an "extended period" of extreme ease in order to effectively cap long-term Treasury yields.

In this tricky public relations task it is quite useful to have a couple of FOMC members seeming to "go rogue" -- Kansas City Fed president Thomas Hoenig urging a higher funds rate (see "Advice and Dissent" January 28, 2010), and Philadelphia Fed president Richard Plosser urging a reduction in the Fed's balance sheet. We have no doubt but that they are entirely sincere. But if they were not there, Bernanke would have to invent them.

Thanks to Hoenig and Plosser, market expectations for the funds rate continue to be greater than zero a year ahead. The futures-implied year-ahead funds rate, at 67 bp, is now nearly as low as it has ever been (please see the chart below). But we think it is not low enough. In fact, it has *never* been low enough -- the funds rate has been zero now for a year and a half, and the futures have *never* correctly predicted it. Even now, near the historic lows for the implied funds rate, we think buying the June 2011 futures is a great "pure play" on an ultra-easy Fed.



Source: Federal Reserve, CBOT, TrendMacro calculations

Bottom line

Amidst false double-dip fears, the 10-year is a trading short at 3.3%. But strategically, the Fed's commitment to an "extended period" of ultra-ease means a range-bound yield with a top near 4%. With the Fed committed to keeping the Treasury yield capped and to lowering solvency risk throughout the economy, high yield bonds are a buy at the well above-average spread of 7%. Don't worry about Hoenig or Plosser. There's "no exit" for the Fed. The funds rate will be zero all this year and probably all next year, and the balance sheet won't be reduced.