MCG Journal

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FIXED INCOME OUTLOOK

As the Federal Reserve Board's Federal Open Market Committee ("Fed") has temporarily halted its recent interest rate hike run, we wanted to look at the impact it had on the performance of the fixed income market. While the Fed is monitoring the economy, focusing heavily on inflation levels, the strength of the housing market is driving investor's expectations in the fixed income market. These two approaches lead to different conclusions as we will discuss. In addition, we examine three scenarios for the future of the fixed income markets.

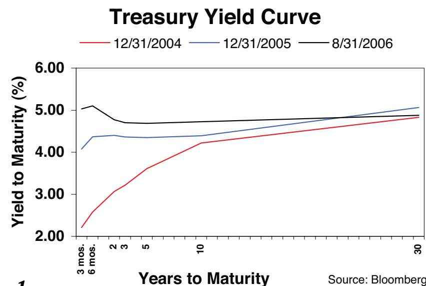

Figure 1

ECONOMY

At the August 8th meeting of the Fed, policy-makers left the benchmark interest rate at 5.25%. This was the first time in 2 years that the Fed has taken a breather from raising short-term interest rates. This is a pause driven by its expectation that the economy is slowing, however, as the Fed is still maintaining its tightening bias. In the September and October meetings, the Fed left rates unchanged but is still inclined to raise rates going forward. The Fed is assuming that a slower economy, plus the lagged effect of a 425 basis point rise in rates (see Figure 1) will result in reduced inflation pressures. The Fed indicated it is seeing continued moderation in economic growth, partly reflecting the cooling of the housing market.

HOUSING MARKET

Initially, the housing market began to slow as affordability dropped due to rising mortgage rates and a continued climb in home prices. Over the last quarter, housing prices have dropped due to less demand. Housing starts plunged 6% in August to its lowest in 3 years. Mortgage activity (new and re-finance) and housing starts have both dropped dramatically from year-end 2005 levels (see Figure 2).

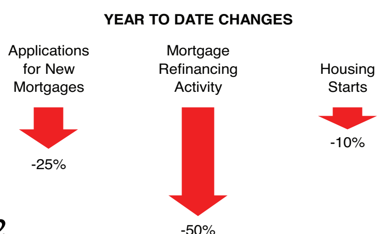

Figure 2

INFLATION

Inflation is a key component driving the Fed's actions and impacting the financial markets. Inflation can be simply thought of as rising prices, or equivalently, a decline in the value of money. Inflation erodes the true buying power of the assets generated through investment returns. For example, a pension plan may have a nominal return of 10% over five years. If inflation is 3% then the real return is only 7%, meaning the plan is only able to purchase 7% worth of goods or services. One measure of inflation is the Consumer Price Index ("CPI"). The CPI is a measure of the average change over time in the prices paid by urban consumers for a market basket of goods and services.

The CPI increased 0.2% in August (see Figure 3). The expectation in the coming months is a rise in the cost of services and labor. The Fed has not changed their tightening bias and has maintained that inflation is their main target. To date, inflation measures are still above their tolerance range. The Fed prefers to see the growth rate for the CPI under 2.5% year over year. Current estimates are between 2.3%-2.4%, slightly higher than the Fed's comfort zone. While the Fed is waiting to see the impact of the recent changes in rates, the market has actually priced in a decrease of rates in the near future. The Fed Fund futures currently imply an easing in the first quarter of 2007. Based on this conflicting information, there appears to be a disconnect between the expectations of the market and the Fed.

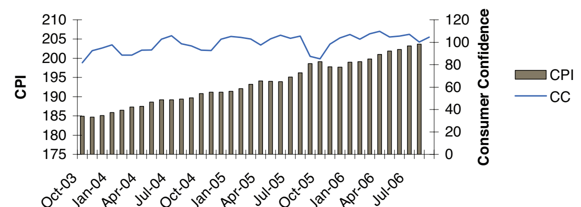

Figure 3

OTHER MACRO INDICATORS

Regardless of the uncertainty with inflation, there are other aspects of the economy that are showing strength. There has been significant growth in corporate profits and strong state and federal tax revenues. Credit spreads remain low, suggesting a continuation of low expectations for credit defaults. Consumer Confidence rose to 104.5 in August though it is still down from its earlier high of 109.8 this past April (see Figure 3).

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To recap, the Fed halted the string of rate hikes, but is maintaining its tightening bias as inflation is above its comfort level. At the same time, the market is expecting a rate cut based on a slowing housing market that investors fear will spill over into the rest of the economy. In addition, corporate profits are strong and expectations for credit defaults are low. The conflicting information suggests an uncertain outlook for fixed income.

FIXED INCOME MARKET

In 2005, performance for fixed income markets ended on a positive but low note. After eight rate increases by the Federal Reserve, bond prices remained high and returns low. The Lehman Brothers U.S. Aggregate Index ("LBAG") returned 2.43%, down 191 basis points from 2004. In addition, the Lehman Brothers U.S. Intermediate Aggregate Index and the Lehman Brothers U.S. Credit Index returned 1.58% and 1.96% respectively (see Figure 4).

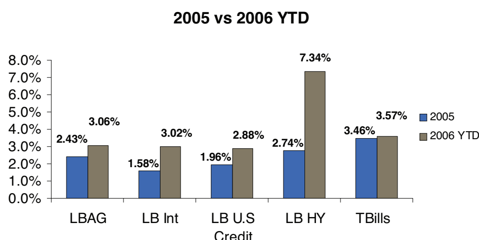

Figure 4

Year to date as of September 2006, returns appear to be on track to outperform last year's results. Through the third quarter, the LBAG has returned 3.06%. The Lehman Intermediate and Credit indices have performed along the same lines, already surpassing last year's total return by 101 bps and 92 basis points respectively. However, even if these two indices continue at the current pace, total year-end returns are only expected to be in the range of 3.5%-4.5%.

In 2006 the structure of the fixed income market changed so that there is no longer a premium return for taking on the risk of longer-term fixed income instruments. The yield curve inverted, meaning that short term rates are higher than long term rates (see Figure 1). Typically investors are compensated with higher yields for extending maturity further out in time. One explanation for the lack of a risk premium is excess demand by foreigners and pension funds for longer maturity bonds. The higher demand in this sector is putting upward pressure on prices, thus keeping yields down. A correction to the yield curve would come at the expense of fixed income investors as bond prices would drop while their yields rise.

OUTLOOK

Based on current market and Fed views, we suggest three possible scenarios that could play out. We have recently come out of a cycle with falling inflation, strong growth, and strong housing so it is unlikely that this would repeat soon. In addition, geo-political uncertainty (the war in Iraq, North Korea's nuclear testing) could have an unexpected impact as well.

SCENARIO ONE

If inflation increases above the Fed's tolerance level and the housing market stabilizes, this scenario would be very bad for bonds. In this scenario, we are assuming that inflation grows due to a strong economy and robust corporate earnings. This would lead to a well performing stock market which could lure away the foreign investors that have been in the long term bond market. Their exit would finally give a lift to long term yields. This combined with the Fed raising rates would raise yields across the curve. The Fed would continue with their tightening bias implying future negative performance for bonds.

SCENARIO TWO

If economic growth and inflation decrease, rates will remain unchanged or may be lowered. If the short end of the yield curve gets cut, prices could appreciate. This scenario has already been seen in the Fed Fund Futures rate. Over the last 6-8 weeks the market has already rallied based on an expected rate decrease. If a rate cut is realized, additional returns depend on the actualization of the data. The economy would need to show continued weakness and decreased inflation. This scenario could be stable to positive for bonds but it is unclear how positive as this information is already priced into the market.

SCENARIO THREE

If economic growth and inflation decrease, rates will remain unchanged or may be lowered. If the short end of the yield curve decreases, prices could appreciate. This scenario is implied in the Fed Fund Futures rate. Over the last 6-8 weeks the market has already rallied based on an expected rate decrease. If a rate cut is realized, additional returns depend on the actualization of the data. The economy would need to show continued weakness and decreased inflation. This scenario could be stable to positive for bonds but it is unclear how positive as this information is already priced into the market.

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