



The Fed Follows Through

Janus Capital's Fundamental Fixed Income team opines on the highly anticipated rate hike.

MARCH 2017

The Federal Reserve (Fed) followed through on its recently hawkish tone Wednesday and increased the federal funds target rate by 25 basis points. This was the second such tightening in three months, but only the third since 2008. Markets, which were expecting more hawkish forward guidance in light of encouraging data trends, interpreted Fed Chair Janet Yellen's announcement as neutral to dovish. Treasury yields rallied in the wake of the announcement and credit spreads resumed compressing.

Following December's rate increase, the U.S. economy continued to perform well, with positive trends in employment data and inflation enabling the Fed to seize the opportunity to raise rates in March. Members of the Federal Open Market Committee (FOMC) continue to anticipate a total of three hikes this year. However, Darrell Watters, Head of U.S. Fundamental Fixed Income at Janus Capital, expects growth and inflation to be challenged in the months ahead, ultimately making it difficult for the Fed to tighten by another 50 basis points in 2017. Without a pickup in wage pressures or a reacceleration of commodity prices, it is unlikely that inflation will increase at the pace of recent months. A stronger dollar would also be deflationary and diminish the Fed's inkling to further tighten. Moreover, there are tail risks on the horizon with the potential to derail U.S. economic growth, including reform disappointment by the Trump administration and the upcoming French presidential election. Speed bumps such as these will likely keep the Fed on a path of modest and gradual increases to avoid destabilizing the economic recovery it promoted over the past eight years.

The Head of Fundamental Fixed Income Risk, Mayur Saigal, however, cautions that if potentially new fiscal policies prove successful and inflation takes hold, markets may be complacent in the number of rate hikes they expect in the long run. The Fed's benchmark rate – which now ranges from 0.75% to 1.0% – is still well below the long-term average. The Fed is keenly watching inflation and will take action when it can to replenish its monetary resources before the next recession hits (although we do not believe this is imminent). If the market realizes that the Fed intends to hike more aggressively than expected, yields on three- and five-year Treasury notes will likely rise as inflation expectations reprice.

As we move toward mid-year, we anticipate the yield curve to flatten with Fed-driven volatility on the front end and range-bound yields on the long end. Absent further inflation, it is difficult to see the yield on the 10-year pushing much beyond 3%. U.S. Treasury securities remain some of the most attractive safe-haven assets, which should keep the long end of the yield curve well bid. While rising rates may negatively impact bond returns in the short term, investing in securities with higher yields presents an opportunity to generate greater income over longer periods of time, something that's been a challenge for bond investors in recent years.

Key Takeaways

- ▶ The Fed's March interest rate hike was widely expected and reflects continued improvement in the U.S. economic outlook.
- ▶ While members of the Fed's policy making committee project two additional hikes in 2017, we expect muted growth and inflation in the coming months to challenge the central bank's objective.
- ▶ We anticipate Fed-driven volatility on the front end of the U.S. Treasury yield curve, with range bound yields on the long end.

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