Fed Balance-Sheet Normalization—This Year?

In its quarterly review, the taxable fixed-income team at Oppenheimer Investment Advisers breaks down central bank policy, economic growth and the investment implications of political uncertainty. In addition, the team discusses key drivers of its strong portfolio performance relative to market indices.

Key Takeaways

- March FOMC minutes revealed that balance-sheet normalization should be passive, predictable and communicated well in advance
- The Fed continues to "thread the needle" by normalizing monetary policy without raising rates too quickly and putting excess pressure on borrowing rates
- The U.S. economy has been mired in slow growth with little likelihood of a breakout in either direction in 2017, but data continues to point toward economic expansion.
- Trump policy agenda items, particularly the repeal of the Affordable Care Act, are causing dissent within the Republican Party. That portends further infighting over tax reform, infrastructure stimulus and defense spending.
- An overweight in corporate bonds has enhanced our performance and we continue to view it as an attractive opportunity amid modest economic growth.

Shrinking the Fed's Balance Sheet

Like many other ardent Federal Reserve watchers, we were somewhat surprised to learn that the normalization of the Fed balance sheet was a topic of discussion at the Federal Open Market Committee's March meeting. After sending a strong signal in February that it would raise the federal funds rate, the FOMC increased the target range to 0.75%-1%. The press conference that followed was typically vague, with Chair Janet Yellen hinting that nothing had been decided regarding the balance sheet.

However, the FOMC minutes, published in the first week of April, revealed detailed dialogue about a potential tapering program. Not surprisingly, the FOMC wants the normalization of its balance sheet to be as predictable and painless as possible. Specifically, central bankers suggested that balance-sheet tapering would begin later this year. The general principals of the process outlined in the minutes were:

- Mortgage-backed securities and Treasury holdings will be treated equally
- Reinvestment of maturities will mostly likely be tapered rather than ending it at once
- Balance-sheet normalization should be passive, predictable and communicated well in advance

For our part, we're skeptical of this timeline for tapering. Right now, we expect the FOMC to increase the federal funds target rate to 1%-1.25% at the June meeting and further signal a start date for balance-sheet tapering to commence. It's important to note that the 10-year U.S. Treasury yield dropped to approximately 2.39% at the end of the quarter from 2.63% before the March meeting. At the start of 2017, the 10-year U.S. Treasury yield stood at 2.45%. The yield curve is flattening (see below) and we expect that trend to continue.

With the unemployment rate now at 4.5% and the Fed's preferred inflation measure, the core personal consumption expenditures index, at 1.8% year-over-year, the FOMC wants, to use Yellen's words, "to be ahead of the curve and not behind it. We don't want to be in a position where we have to raise rates rapidly, which could conceivably cause a recession."

Source: Bloomberg

In our quarterly commentaries during the past three to five years, we have demonstrated that the FOMC routinely forecasts more robust economic growth than what actually occurs. In our opinion, the FOMC has done an exceptional job of managing monetary policy since 2008. Perhaps it is becoming increasingly concerned by the duration of this recovery, despite its tepidness, and feel an urgent need to unwind extraordinary policy accommodations to be best positioned for the next recession.

We keep a basic economic fact at the forefront of our thinking: U.S. Treasury yields consist of a real rate of return and an inflationary component. The Fed wields more influence over short-term interest rates while inflation expectations are more influential over long-term interest rates. Subsequently, while a hawkish Fed boosts short-term rates, long-term inflation expectations are reduced, putting downward pressure on longer-term rates. A federal funds rate approaching or exceeding 2% in 2018, as predicted by the Fed's "dot plot," risks flattening the yield curve with 10-year Treasury yields at 2.39%.

In addition, reducing or tapering the Fed's balance sheet would put even more upward pressure on short-term rates. Perhaps that's why we're hearing about the U.S. Treasury's plan to issue longer-term paper, creating more supply at the longer end of the curve and avoiding a flat or inverted yield curve. What is paramount, in our view, is that the Fed continues to "thread the needle" by normalizing monetary policy without raising rates too quickly and putting excess pressure on borrowing rates for consumers and businesses.

Modest But Stable Economic Expansion

On the jobs front, March employment gains came in well below expectations, adding 98,000 jobs versus expectations of 180,000 jobs. It's important to remember that February was unseasonably warm, which created a pull-forward effect, and a major winter storm hit the East Coast in mid-March, which slowed hiring activity.

However, debating the bumps in the month-to-month numbers is somewhat of a side show. What's important to investors is the broader trend, which continues to be positive. The unemployment rate dropped 0.2% to 4.5%, representing the lowest reading since May 2007. The U-6 underemployment rate, which offers a broader measure of labor utilization, fell to 8.9% in March from 9.2% in February. This marked the lowest level of underemployment since December 2007. Job numbers have now grown for 85 consecutive months.

Still, tighter labor conditions haven't added much wage pressure, therefore inflation remains muted. Average hourly earnings for private-sector workers rose 2.7% year-over-year in March, lower than the December 2016 reading of 2.9%—the strongest since June 2009.

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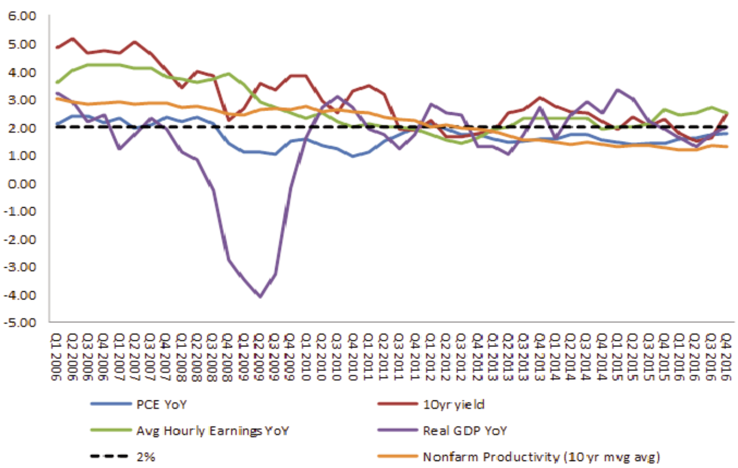
Core PCE, which excludes food and energy costs, increased 1.8% year-over-year for February 2016. Inflation remains stubbornly below the FOMC's 2% target, but deflation fears have dissipated. With the recent leveling of wage growth, we don't anticipate an accelerated increase in core PCE anytime soon. This lack of inflation will likely give the FOMC cover to delay a third rate increase in 2017 but potentially implement its tapering plan.

In terms of overall economic growth, gross domestic product continues to chug along. Annualized fourth-quarter real GDP growth was 2.1%. We are nearing eight consecutive years of growth—that's 96 months! For comparison, the average post-World War II recovery has been 61 months. The first-quarter 2017 Bloomberg consensus GDP estimate of 2.5% is more elevated than what has been experienced in recent years. We consider this an aberration, perhaps even a "Trump bounce." GDP growth should level out in the next several quarters, growing approximately 2.5% for the year.

To help see the bigger picture, the chart below illustrates the convergence of various economic performance metrics over the past 10 years. This chart suggests that the U.S. economy has been stuck in a slow-growth mode with little likelihood of a breakout from trend in either direction for at least the next three to four quarters.



Source: Bloomberg

Gridlock Inside the Beltway

Last quarter, we highlighted the challenges to a repeal and replace of the Affordable Care Act. As anticipated, those challenges resulted in a continuing delay on a vote by Congress. The basic hurdle is the wide philosophical dispersion within the Republican Party. While moderates want to retain many positive aspects of Obamacare, conservatives want to scrap it altogether.

Rather than engage in a political debate over its merits, we want to point out that the same factions are likely to be at odds when it comes to tax reform, infrastructure spending and defense spending. The struggle stems from the financial implications of policy decisions: are they budget neutral (a conservative requirement) or do they require further increases to the ballooning national debt?

Corporate tax reform, particularly the repatriation of internationally earned profits, would bolster corporate balance sheets and potentially boost domestic capital spending. However, what seems to be a topic everyone can agree on is likely to create controversy. Perhaps moderates from both sides reaching across the aisle is a way to achieve some progress in Washington D.C.

Overweight in Corporates Pays Off

The first quarter of 2017 was relatively muted for fixed-income investors. The Fed raised rates by 0.25% in March but there was little movement in the bond market. The 2-year U.S. Treasury yield rose to 1.26% from 1.21% during the quarter. Further out on the yield curve, the 10-year U.S. Treasury yield rose to 2.44% from 2.37%. Corporate securities—both investment-grade and high-yield bonds—overtook Treasury securities as the best performers for the quarter.

For the first quarter, the Barclays Capital U.S. Aggregate Index returned 0.82%. Corporate securities returned 1.22% while Treasuries returned 0.67% in the quarter. Bonds with longer maturities performed better than those with shorter maturities and lower-quality securities outpaced higher-quality securities. The BofA/Merrill Lynch High Yield Master II Index gained 2.71% in the quarter.

Once again, our composites posted strong performance versus their respective benchmarks in the quarter. As we have mentioned in our past quarterly commentaries, we have structured all of the accounts with an overweight to the corporate sector, which has enhanced our performance. We continue to believe this overweight in corporate bonds offers the best opportunity as the economy slowly expands.

Ultimately, our bottom-up investment process and extensive research focus helps us identify relative value opportunities in the marketplace, giving us confidence in the risk-reward tradeoffs in our portfolios. While market fluctuations can cause short-term underperformance, our long-only style of investing has delivered positive results with reduced volatility over the long term. If you have any questions on strategy, performance or business development, please do not hesitate to contact us.

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