So Close ... But We Understand

Well, another Federal Reserve (Fed) meeting has come and gone without a rate hike. No real surprise there; May's discouraging employment report shut that door. Probably the biggest takeaway from the mildly dovish June 15th meeting was the general reduction in the timing and pace of future rate hikes relayed through the Fed dot plot. To be fair, the Fed had lots of ammunition to defend its decision, including the disappointing U.S. jobs data and the looming June 23rd Brexit vote. We are not big believers in the markets driving Fed policy, but there is simply no way the Fed can surprise markets with an unexpected rate hike in the current environment. There were the obligatory pundit accusations of Fed timidity and cluelessness. But that's an old hat and the constant disparagement of the Fed has us thinking it may be getting a little bit of a raw deal. Since exiting such massive and extraordinary monetary policies has never been done before, perhaps we've all been too dismissive of the headway made so far and the challenging cross-currents facing the Fed. After all, how do we know the Fed's current path isn't the best option?

We don't. But we'd prefer the Fed pick up the pace and risk giving markets some tough love. We believe the Fed should (but probably won't) lift rates 25 basis points in July and again in December. Our core rationale is straightforward – the benefits of a very low interest rate policy are largely spent, but the negative impacts remain and may be accelerating. Low rates helped reflate asset values from Great Recession lows, stabilize the housing market and allow for some consumer and corporate balance sheet repair. But continued low rates will simply not spark a new wave of home building or business investment – the typical mechanisms for monetary policy to spur economic activity. So what's left is capital dislocation, corporate re-leveraging and perhaps most damaging, a lousy yield environment for insurers, banks, pensions and savers. A growing and vibrant economy requires a strong banking system, properly incented to take on a certain amount of risk. A 0.25% to 0.50% policy target rate is just not conducive for creating such an environment. And isn't there something inherently perverse about overly-levered economies rewarding borrowers and punishing savers? We think so. A prolonged and measured rate hike cycle with a well-signaled terminal funds rate of around 2% seems like the right prescription to us. The Fed will likely get there eventually, just not as quickly as we would prefer.

Despite the pullback of dot-plot rate hike forecasts, we think the Fed actually wants to raise rates and will take the first opportunity to do so. Defining the right conditions for that opportunity probably gets the Fed in the most trouble with investors, as the definition seems to oscillate between "data dependency" and "market stability" with stability trumping data – which is why the May employment report was such a buzzkill. Prior to the jobs report, market stability seemed to be greenlighting a summer rate hike and all the data had to do was follow trend. It didn't happen. In turn, the market shifted to risk-off and removed its implied permission to hike rates.

Despite the lack of progress toward policy normalization, we suspect Fed policymakers are getting ready to put a fork in negative interest rates as an effective growth policy – which is at least something. There is mounting opinion

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The Fed's dot plot is a forward-looking graphic depiction of the individual Federal Open Market Committee (FOMC) participants' assessments of the appropriate federal funds rate target level.

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that European Central Bank (ECB)-induced negative rates are damaging European business, consumer and investor confidence – a rather contrary outcome for policymakers. The ECB admitted as much when it recently started buying corporate debt in lieu of further lowering already negative rates. In Japan, negative bank rates have increased consumer demand for hard currency – a terrific development for sales of home safes, gift cards and the proverbial mattress, but a lousy recipe for increasing lending, the velocity of money and risk taking. Don't expect any grand pronouncement dismissing negative rate policies. Some gentle nodding in that direction is the most investors should expect, as no central bank would admit to having fewer tools to manage its economy.

We are not trying to be Fed apologists here, but simply acknowledging a stone cold fact – the Fed is the only game in town to promote financial stability and U.S. economic growth. Washington is so dysfunctional that even productive legislation both sides can agree on (corporate tax reform leaps to mind) has almost zero chance of passing. And exasperatingly, every time Fed Chair Janet Yellen testifies on Capitol Hill, she is criticized for not doing enough to help the economy – apparently you lose your sense of irony when elected to Congress. Or maybe she's criticized for doing too much. Honestly, it's hard to keep track.

So what does all this mean for the fund portfolios? We are of the mind May's employment print was an aberration and not a trend. We also lean toward Britain remaining in the European Union, but that is based on our belief people generally favor the status quo over massive change rather than on any unique insight. This would lead us to suggest current yield levels are too low and the 38% probability market futures are placing on a single fed funds rate hike in 2016 is underestimated. That being the case, for Prime Obligations the impact is limited, as we are more concerned with positioning the portfolio for our new retail fund launch in July and ensuring we are keeping adequate liquidity. The government portfolios will make more use of floating-rate notes as they become more attractive vs. their fixed-rate counterparts, especially with LIBOR rates likely to rise due to money fund reform. But market conditions and sentiment can change quickly and we will be alert for better opportunities to add yield should the curve move higher.

Source:

Bloomberg

FOMC Meeting Projections Materials, June 15, 2016

Definitions

Basis Point (bps) is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
Brexit is a British referendum to determine whether the United Kingdom will remain a part of the European Union (EU).
European Central Bank (ECB) is responsible for the monetary system of the EU and the euro currency. The bank was formed in Germany in June 1998 abd works with the other national banks of each of the EU members to formulate monetary policy that helps maintain price stability in the EU.
Federal funds rate is set by the Federal Reserve Board. It is the interest rate charged by banks with excess reserves at a Federal Reserve district bank to banks needing overnight loans to meet reserve requirements. The federal funds rate is considered a sensitive indicator of general interest-rate trends.
Federal Open Markets Committee (FOMC) is a 12-member committee which sets credit and interest rate policies for the Federal Reserve System.
Federal Reserve (Fed) is the United States central banking system. It is comprised of 12 regional central banks, known as the Federal Reserve Banks, which are owned by private banks. The Fed is governed by a 7-member Board of Governors, who regulates interest rates, availability of bank credit and sets other monetary policies such as legal reserve requirements for banks.
A Floating-Rate Security has a variable interest rate. The adjustments to the interest rate are usually made every six months and are tied to a certain money market index. Also referred to as a floater.
LIBOR (London Interbank Offered Rate) is the interest rate at which banks can borrow funds from other banks in the London interbank market. It is the world's most widely used benchmark for short-term interest rates.
LIBOR Rates are rates that the most creditworthy international banks dealing in eurodollars charge each other for

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large loans. The LIBOR rate is usually the base for other large eurodollar loans to less creditworthy corporate and government borrowers.

Monetary Policy is the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Yield Curve is a line tracing relative yields on a type of bond over a spectrum of maturities ranging from three months to 30 years.

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