FOMC OUTCOME PROVIDES TWO POSITIVES FOR BONDS

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As expected, the Federal Reserve kept its current policy stance unchanged at its meeting on December 15-16, signaling it will maintain the Fed Funds rate at its current near-zero level and will continue adding stimulus through its QE purchases to support the economic recovery from the pandemic. The Fed also took an important step at this meeting, though, by strengthening its forward guidance with respect to QE, tying the outlook for its asset purchases more tightly to the economy's performance going forward.

The Fed has already been providing performance-based guidance on the likely path of the Fed funds rate going forward, noting it expects to keep the funds rate unchanged at its current level until full employment is reached and "inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time." At this meeting, the Fed similarly introduced outcome-based forward guidance on the likely path of its QE purchases, noting it "will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities by at least $40 billion per month until substantial further progress has been made toward the Committee's maximum employment and price stability goals." While the Fed retained flexibility through the vagueness of the condition "substantial further progress" (allowing, we think, for QE tapering before the Fed considers rate hikes), it was at the same time fairly specific in specifying minimum dollar amounts for its purchases going forward.

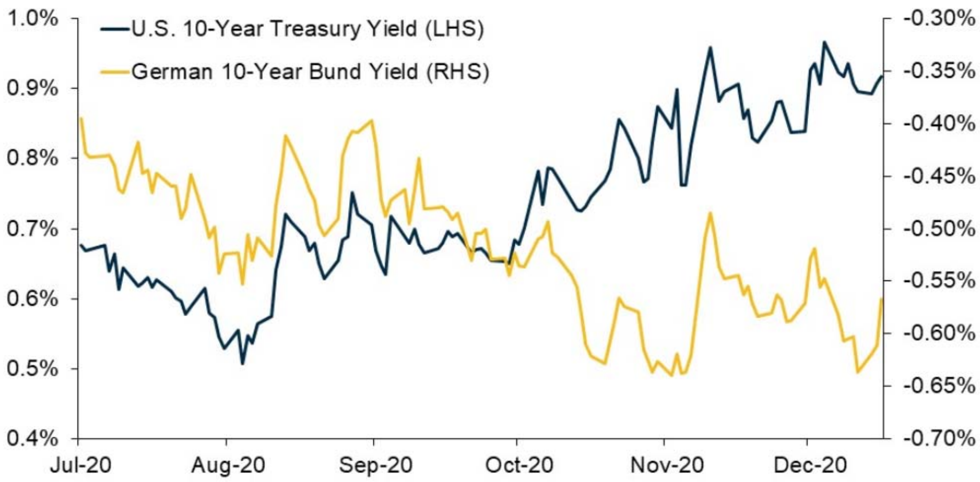
The Fed's updated economic projections at its December meeting signaled a more optimistic view on the economy over the next several years, with the unemployment rate now expected to improve at a faster pace than previously projected, reaching 5% by the end of 2021 and 4.2% (roughly the Fed's estimate of full employment) by end-2022. But inflation is still projected to undershoot the Fed's 2% target right through at least the next two years, despite a projected Fed funds rate that is on hold over that same period and beyond.

Fed Chairman Powell struck a more cautious tone with respect to the near-term economic outlook, however. With virus case counts elevated across much of the U.S., and economic growth slowing heading into the final stretch of 2020, the Fed's accommodative policies remain critical. But Fed Chairman Powell noted that interest-rate sensitive sectors of the economy, e.g. the housing market, have already responded strongly to the Fed's accommodative stance. Significant further improvement in other parts of the economy will likely depend on the rollout of the vaccine. Powell reiterated a strong case is to be made for another fiscal package in the interim that would help those households and businesses hit particularly hard by the pandemic to bridge the gap until the vaccines are deployed in the coming months. Indeed, Congress appears to be making progress this week towards passage of another support package.

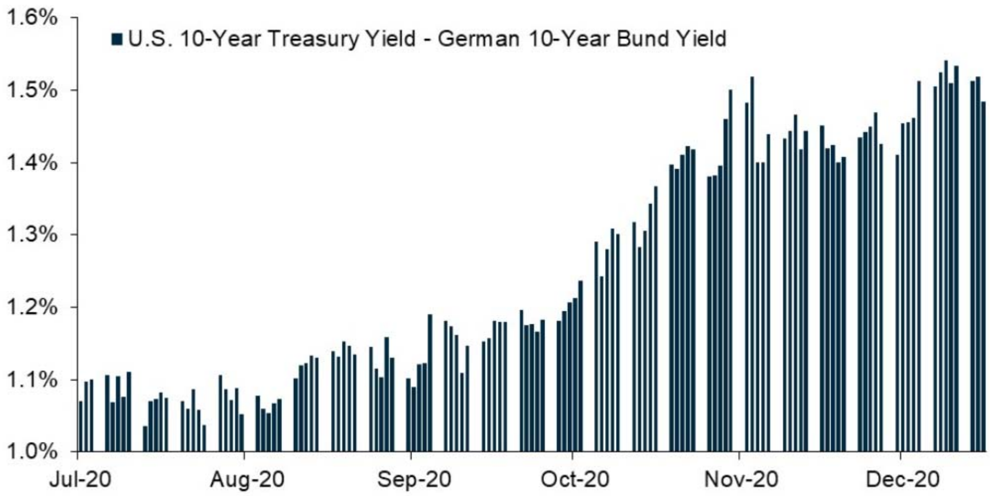
Two Positive Aspects for Bonds

Perhaps ironically, the Fed's commitment to achieving its objectives of full employment and 2% inflation—which might seem to be bond bearish—are likely to prove positive for the bond market from two perspectives. First, to achieve its objectives, the Fed is likely to keep rates lower for substantially longer than what is currently priced into the yield curve. In our view, the rise in long Treasury yields over the last several months has pushed Treasury yields to attractive levels not only in absolute terms, but also relative to other DM country yields (Figure 1).

FIGURE 1: WHILE A YIELD OF 1% ON THE U.S. 10-YEAR TREASURY MAY NOT SOUND HIGH, IT APPEARS HIGH NOT ONLY RELATIVE TO THE LIKELY COURSE OF THE FED FUNDS RATE, BUT ALSO RELATIVE TO ITS GLOBAL PEERS.



Source: Bloomberg



Source: Bloomberg

Additionally, if the past is any indication, the Fed solidifying its commitment to substantial liquidity injections—the current $120 billion / month QE pace rivals the peak rate of purchases following the GFC—is likely to boost risk appetite, driving further outperformance by the so-called spread sectors (e.g., investment grade and high yield corporate bonds, structured product, and emerging market debt) relative to higher quality government bonds.

Looking further ahead, while the current combination of aggressive monetary stimulus and the rapid economic recovery from the Covid crisis is raising concerns of higher inflation and rates in some quarters, we believe that in the months ahead, the current economic momentum is likely to give way to the overarching secular bond bullish fundamentals of ageing demographics and high debt burdens, which have only intensified over the period of the crisis. As a result, we believe the U.S. 10-year Treasury is poised to crest around current levels. While the market may be subject to bouts of volatility thanks to the uncertain backdrop, this low and range bound environment for cash and government yields is likely to continue to fuel a search for income, supporting an overall positive backdrop for fixed income over the intermediate to long term.

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