U.S. Federal Reserve policy shifts from calendar to economic targets: Considerations for investors

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SUMMARY

Recent changes at the U.S. Federal Reserve, known as the Fed, had serious consequences for investors and plan fiduciaries. No longer can we assume that rates will stay low until 2015 or some date certain in the future. Interest rates can change based on economic conditions. In summary, changes announced at the Fed's final meeting of the year include:

- Economic targets now trump calendar targets: Instead of promising to keep rates low until mid-2015 or some other date, the Fed is now targeting unemployment at 6.5% and inflation at 2.5%.
- Purchases of mortgages via a third round of quantitative easing (QE3) will now include more U.S. Treasuries to offset the impact of the expiring Operation Twist.

At its last meeting in December 2012, the Fed announced it would expand QE3, its quantitative easing asset purchase program, in light of the coming expiration of Operation Twist at year-end. During Operation Twist, the Fed was swapping about $45 billion in short-term U.S. Treasuries for an equal amount of long-term Treasuries. In addition to the original QE3 purchase plan of $40 billion in mortgage-backed securities per month, the Fed will now buy an additional $45 billion in Treasury securities. This program has now been extended indefinitely.

THE ROLE OF THE FEDERAL RESERVE

The Fed is charged by the U.S. Congress with two objectives: controlling inflation and minimizing unemployment. Historically, the Fed has communicated in general, nonspecific terms about these two opposing goals. This QE3 announcement, however, is the first time the central bank has publicized such a specific economic objective. This illustrates the concern of the Federal Reserve Board and its chairman Ben Bernanke about what Bernanke labeled "a waste of human and economic potential."

With this change in policy, the Fed released new economic projections showing that most of its senior officials did not expect to reach the goal of 6.5% unemployment until the end of 2015, raising questions of why it was not moving to expand its economic stimulus campaign. But instead of financing the purchases by selling short-term Treasuries, the Fed will credit banks that sell the bonds with new reserves, essentially creating money, as it now does in purchasing mortgage bonds. The published forecasts show that Fed officials expect the economy to expand between 2.3% and 3% in 2013, again slightly below their prior forecast. Fed officials have repeatedly overestimated the health of the economy and the pace of the recovery, and the latest changes, while relatively small, continue that pattern. However, now that some tax increases have been enacted (payroll tax increase of 2%) and the "sequester" has begun implementation, the Fed's stimulus campaign will have less of an impact and the economy may return to recession.

THE FEDERAL RESERVE TOOLBOX

"If we could wave a magic wand and get unemployment down to 5% tomorrow, obviously we would do that," Bernanke said when asked if the Fed could do more. "But there are constraints in terms of the dynamics of the economy, in terms of the power of these tools, and in terms that we do need to take into account other costs and risks that might be associated with a large expansion of our balance sheet," he also said, referring to the monthly purchases of securities.

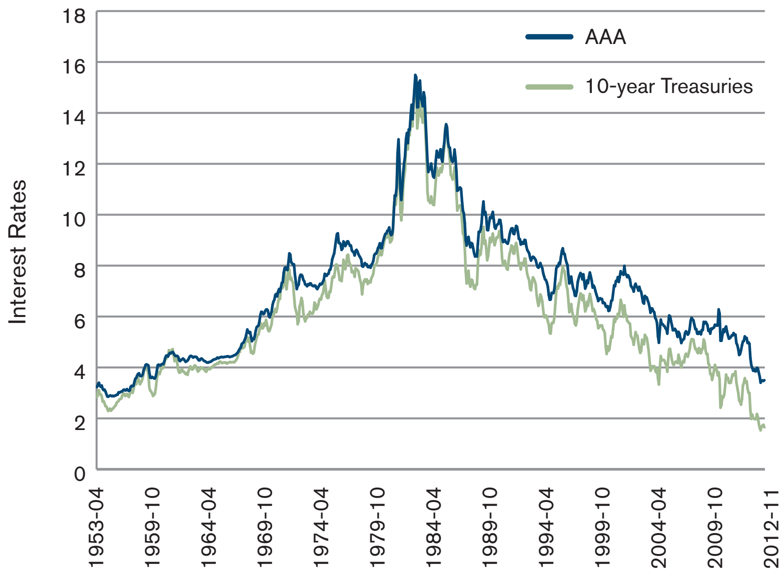
The unemployment rate in February was 7.7%—it has not been below 6.5% percent since September 2008—while the rate of inflation in recent months is lower than the 2% annual rate that the Fed considers healthiest. "Bernanke is pulling out all the stops to kick this economy back into a higher gear," said Chris Rupkey, chief financial economist at Bank of Tokyo-Mitsubishi UFJ Ltd. in New York. "They are buying everything in sight—Treasuries, mortgage-backed securities—and will keep rates low until everyone who wants a job has one."

The Fed has more than tripled the size of its balance sheet with three rounds of large-scale asset purchases intended to bring down long-term borrowing costs and stimulate purchases of homes and cars. Bernanke broke new ground with the latest round of so-called quantitative easing by setting no limit on the size or duration of the program. At their December 2012 meeting, Federal Open Market Committee (FOMC) participants lowered their forecasts for growth in 2013. They now see the economy expanding at a rate of 2.3% to 3%, compared with 2.5% to 3% in September. The average pace of growth for the decade through 2007 was 3%.

BERNANKE'S VIEW

Bernanke, who lowered the benchmark interest rate almost to zero four years ago, yesterday said the Fed's "ability to provide additional

FIGURE 1: HISTORICAL INTEREST RATES SINCE 1953



Source: Federal Reserve Bank of St. Louis, http://research.stlouisfed.org/fred2/

accommodation is not unlimited," which is "an argument for being a little bit more aggressive now."

"A return to broad-based prosperity will require sustained improvement in the job market, which in turn requires stronger economic growth," Bernanke said yesterday.

When he was a Princeton University professor in January 2000, Bernanke presented a paper with the title "Japanese Monetary Policy: A Case of Self-Induced Paralysis?" In it, he criticized the unwillingness of monetary authorities to experiment, "to try anything that isn't absolutely guaranteed to work."

In slumps, policy makers need "Rooseveltian resolve," he wrote, which he described as a "willingness to be aggressive and to experiment—in short, to do whatever was necessary to get the country moving again."

Bernanke shunned orthodoxy as the global credit crisis unfolded, giving out more than $2 trillion in emergency aid through six loan programs, currency swaps with other central banks, and the rescues of Bear Stearns Cos. and American International Group Inc. (AIG).

WHEN WILL THEY CHANGE?

Rates have been trending downward for quite some time (see the chart in Figure 1) but when will they go back up? After the 2012 December meeting, the FOMC statement noted:

In determining how long to maintain a highly accommodative stance of monetary policy, the Committee will also consider other information, including additional measures of labor market conditions, indicators of inflation pressures and inflation expectations, and readings on financial developments. When the Committee decides to begin to remove policy accommodation, it will take a balanced approach consistent with its longer-run goals of maximum employment and inflation of two percent.

But in perhaps the clearest indication of the Fed's philosophical shift, the FOMC said Wednesday that it would not relent in its focus on unemployment unless the medium-term outlook for inflation rose above 2.5%. The change was supported by 11 of the committee's 12 members. The only dissent came from Jeffrey M. Lacker, president of the Federal Reserve Bank of Richmond, who has repeatedly called for the Fed to do less. He says he believes the policies are ineffective and could inhibit the central bank's ability to control inflation.

The Fed has held short-term interest rates near zero since December 2008, and it said in September that it intended to do so until at least mid-2015.

IS THE BOARD UNITED?

Fed Chairman Ben Bernanke reaffirmed that the Fed's highest priority is job growth. Some of Mr. Bernanke's colleagues, and some outside economists, argue that telling investors how the economic situation must change in order to warrant a shift in policy might be more convincing, and more potent, than publishing an estimated endpoint.

During the post-meeting press conference, Fed Chairman Ben Bernanke did concede that there could be unintended consequences of such aggressive monetary easing.

"The accommodation switch has been turned on," wrote Michael Gapen, senior U.S. economist at Barclays. He added that the new guidelines "could very well overcome some of the previous confusion surrounding date-based policy rate guidance."

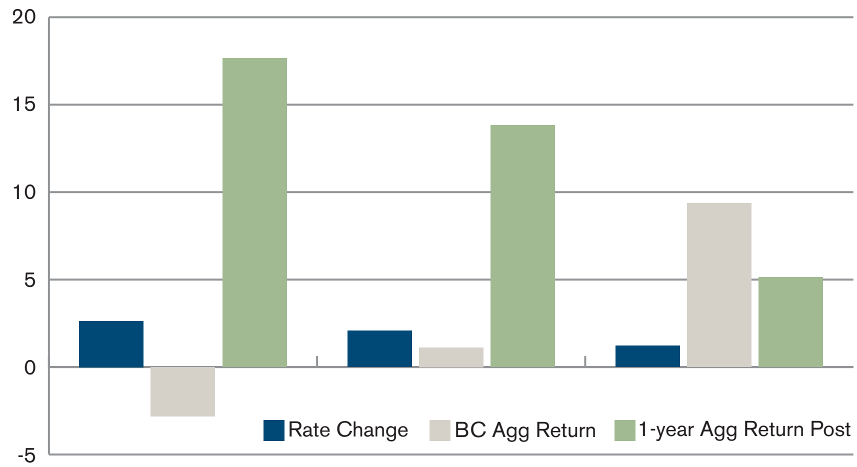
He reiterated that the new economic targets—of unemployment and inflation—are tied to the Fed's rate policy, not its quantitative easing policy. And over the last year, a group of officials led by Charles L. Evans, president of the Federal Reserve Bank of Chicago, convinced their colleagues that the Fed was falling short on the unemployment front. "Imagine that inflation was running at 5% against our inflation objective of 2%," Mr. Evans said in a September 2011 speech first describing the proposal. "Is there a doubt that any central banker worth their salt would be reacting strongly to fight this high inflation rate? No, there isn't any doubt. They would be acting as if their hair was on fire. We should be similarly energized about improving conditions in the labor market." Evans urged the adoption of thresholds and said the central bank should "add very significant amounts of policy accommodation" to bring down unemployment, even at the risk of a temporary increase in inflation.

A year later, the idea was backed by President Narayana Kocherlakota of Minneapolis, who had earlier criticized the Fed's easing policies. Fed Vice Chairman Janet Yellen and the Boston Fed's Eric Rosengren backed the concept. In a November 27 speech, Evans spelled out the numerical benchmarks that were adopted in December. "The Fed is all in," said Diane Swonk, chief economist for Mesirow Financial Holdings Inc. in Chicago. "They are absolutely committed to averting the mistakes of the Japanese and of the Great Depression. They will not stop too soon. He is willing to take the risk of unintended consequences."

WHEN WILL IT STOP?

A tad more surprising—although speculation about it had been higher recently—was the effective replacement of the calendar target for the Fed's future plans with economic thresholds. Recall that the Fed's language had indicated it was going to keep rates "exceptionally low" until mid-2015—that reference was not in the December statement. Instead, the Fed has now explicitly targeted the unemployment rate and inflation (the Fed's dual mandates).

FIGURE 2: RATE CHANGES AND RETURN



	OCT. 1993 TO NOV. 1994	OCT. 1998 TO JAN. 2000	JAN. 2009 TO MAR. 2010
10-YR TREASURY RATE CHANGE	2.63%	2.07%	1.21%
BC AGG RETURN	-2.81%	1.12%	9.37%
1-YEAR AGG RETURN POST	17.65%	13.83%	5.14%

Source: Morningstar Direct

Specifically, the Fed said interest rates will stay low "at least as long" as the unemployment rate remains above 6.5% and if inflation "between one and two years ahead" is projected to be no more than 2.5%. The committee "views these thresholds as consistent with its earlier date-based guidance." The Fed will also continue reinvesting its portfolio of maturing housing debt into agency mortgage-backed securities and will resume rolling over maturing Treasury securities.

WHAT SHOULD WE DO?

Certainly rates are low but what will take them higher? Because of the Fed's purchase of bonds, rates have been forced artificially lower in an attempt to stimulate the economy. Global economic growth will increase global demand for capital and resources, and could take rates higher. The concern most economists and investors have centers around the velocity of money. With the Fed "creating reserves" they are in effect printing money. The classic Econ 101 situation of "too many dollars chasing too few goods" would suggest higher inflation would cause bond investors to expect a reasonable real return and force the market to raise interest rates. Bernanke has suggested the Fed can remove liquidity from the system in an organized and timely way, but many investors are concerned it's just a matter of time before inflation and interest rates must go up.

Most investors have an allocation to fixed income and as long as rates have been heading down, risk wasn't much of an issue. Even though interest rates have very little room to head lower (which they have done), investors have been complacent about pending rate increases. The Fed's policy shift from time-based goals to goals based on economic results will require investors to be more diligent in analyzing and reacting to changes in the interest rate environment. The implication by the Fed is that things may change sooner rather than later, so get your risk-house in order. There are a number of ways to combat this expected interest rate increase.

SHOULD WE SELL OUR FIXED INCOME?

Fixed income has a place in a diversified portfolio, certainly in portfolios with long time horizons. The Barclays Capital Aggregate Bond Index (BC Agg Index) has been negatively correlated to large-cap equity, small-cap equity, and international equity. If we look at some time periods when rates increased more than 1% and examine the returns to a broad bond index, it will provide some insight into what direction and magnitude we might expect (see the chart in Figure 2). For example, from October 1993 to November 1994,10-year Treasury rates increased 2.63%. During that time period, the BC Agg Index declined by 2.81%. However, in the 12 months following November 1994, the BC Agg Index gained 17.65%. In another time period when 10-year Treasury rates increased, October 1998 to November 2000, rates increased 2.07% and the index was actually up 1.12%. Again, the 12 months following the rate increase saw a return of 13.83%. In a more recent time period, January 2009, rates were low, 2.52%. From that date to March 2010,10-year Treasury rates increased 1.21% and the BC Agg Index returned 9.37%. Over the next 12 months, the index produced a total return of 5.14% (and lower-quality bonds did even better). This positive return in the BC Aggregate Bond Index is possible because while Treasury rates are going up, the rate for spread products (corporates, high-yield, etc.) is not going up as much (spreads are tightening).

CONSIDER SHORTER DURATION

For most investors, their fixed-income portfolios are managed with a core or core plus strategy, with a duration (interest rate risk) similar to the BC Agg Index, around four and a half years. If this is your only fixed-income manager, a rate increase of 1% will send your bond market values down 4.5%. Of course, your bond holdings will now generate an annual coupon that is 1% higher, but that will be compounding on the new, lower market value. Consider adding a fixed-income manager to your lineup that has a lower duration. The yield and expected return will be lower over long periods of time, but the reduction in interest rate risk should provide some downside protection in a rising rate environment.

CONSIDER A MANAGER WITH FLEXIBILITY

For greater flexibility, consider having a manager with a broad mandate and a complete toolbox. Managers (or funds) with wide latitude to adjust their durations and the use of different spread products can better protect their portfolios in challenging bond markets (assuming they have alpha generating skill).

DIVERSIFY YOUR FIXED INCOME

As rates rise, different types of bond portfolios will be affected in different ways. In general, spread products (corporate bonds and high-yield bonds) benefit from higher yields. They will frequently experience smaller rate increases than U.S. government bonds when rates rise. And as countries are affected differently, non-U.S. bond portfolios can offer diversification to a fixed-income portfolio. Consider adding a non-U.S. fixed-income manager to your menu.

CONSIDER INFLATION PROTECTION

Additionally, if interest rates go up because of higher inflation or expected inflation, there are a few non-perfect asset classes investors can use to provide some protection. Treasury inflation-protected securities (TIPS) are an obvious choice to gain inflation protection in a bond portfolio. The challenge for TIPS is that they are typically longer-term bonds, so the gains in coupon and terminal par value are significantly offset (in the short run) by declining market values (interest rate risk). Commodities and real estate can provide some protection as well, though implementation can be a challenge for some plans and investors.

CONCLUSION

While it is a mathematical certainty that if rates go up, the value of bonds will go down, it does not have to negatively impact your portfolio over long periods of time. While rates increase, fixed income will be negatively impacted, but ultimately higher rates will compound into higher returns. The impact of the rate increase can be mitigated, and with the Fed more likely to move sooner rather than later to adjust these rates, plan sponsors and trustees should be acting now to address opportunities in their plans. Defined contribution (DC) plans should look at investment options that are appropriate for their participants. Plans that have stable value options will likely not be able to offer short-term bond funds, which is due to the competing nature of that asset class. Also, some stable value managers view TIPs as a competing option. Those plans can, however, look at global fixed income as well as high yield.

Pension plans and endowments have more flexibility, and of course don't have the communication and education challenges of a defined contribution plan. Those organizations can look at adding managers to their lineups and/or giving skilled fixed-income managers more tools, such as the ability to use high-yield or international fixed income. With the Fed's move to economic targets rather than date-based indications, trustees should prepare for a higher-rate environment now and plan for what to do when rates increase and stabilize.

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