Stable Yields, Flatter Curve - Market Expectations for March Fed Funds Rate Hike Rise Sharply

Treasury yields have remained within a relatively narrow range so far this year despite stronger economic data, higher inflation, and indications that the Fed will likely hike the Fed Funds rate in March. Economic strength was evident in the ISM manufacturing (56.0) and non-manufacturing (56.5) indices, as well as the January payroll report (227,000 new jobs). The Fed’s preferred inflation gauge has nearly reached the 2.0% target (January headline PCE +1.9% YoY; core PCE +1.7% YoY).

Upward pressure on Treasury yields from an improving economy has been counteracted by several factors including: 1) uncertainty regarding the details of the President’s fiscal agenda 2) the risk of a surprise election outcome in France in coming months, and 3) very low levels of interest rates in Europe and Japan. Nevertheless, “animal spirits” are running high. The U.S. Conference Board’s measure of consumer confidence reached the highest level since 2001, and the small business optimism index from the National Federation of Independent Business (NFIB) hit the highest level since 2004 on the prospect of reduced regulation. Still, the 10-year Treasury has stayed within a 20 bps range (2.31% - 2.51%) through the first two months of the year and the yield curve has flattened. After the Fed left rates unchanged at its Feb 1 meeting, market-implied odds of a March Fed Funds rate hike fell to just 24%. However, hawkish commentary from multiple Fed speakers, including NY Fed Governor Dudley stating that the “case for tightening has become a lot more compelling,” drove the odds of a March Fed Funds rate hike over 50% at month end (and to 80% on March 1st).

Credit Spreads Tighten as Issuance Slows

Corporate credit spreads tightened 6 bps in February to 115 bps as fundamentals remained solid and strong demand was met with limited issuance. Barclays data shows fixed-rate investment-grade corporate issuance declined to $83B in February after exceeding $217B in January.

Positive Returns, Corporates Outperform

All major fixed income sectors posted positive returns in the month but robust demand for investment-grade corporate issuance declined to $83B in February as the yield curve has flattened. After the Fed left rates unchanged at its Feb 1 meeting, market-implied odds of a March Fed Funds rate hike fell to just 24%. However, hawkish commentary from multiple Fed speakers, including NY Fed Governor Dudley stating that the “case for tightening has become a lot more compelling,” drove the odds of a March Fed Funds rate hike over 50% at month end (and to 80% on March 1st).
Disclosures

This is not a complete analysis of every material fact regarding any company, industry or security. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

Fixed income is generally considered to be a more conservative investment than stocks, but bonds and other fixed income investments still carry a variety of risks such as interest rate risk, credit risk, inflation risk, and liquidity risk. In a rising interest rate environment, the value of fixed-income securities generally decline and conversely, in a falling interest rate environment, the value of fixed-income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield.

Indices are unmanaged, and are not available for direct investment. Past performance is not a guarantee of future results.

The Bloomberg Barclays Aggregate Bond Index is an index comprised of approximately 6000 publicly traded bonds including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years.

The Bloomberg Barclays Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt.

The Bloomberg Barclays Intermediate Government/Credit Index is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between one and ten years.

The Bloomberg Barclays Government/Credit Intermediate Index (1 – 3 yr.) is a combination of the Government Index which measures government-bond general and Treasury funds, and the Credit Bond Index, which is a market value-weighted index which tracks the returns of all publicly issued, fixed-rate, nonconvertible, dollar-denominated, SEC registered, investment grade Corporate Debt with maturities between zero and three years.

The Bloomberg Barclays U.S. Treasury Index includes public obligations of the U.S. Treasury. Treasury bills are excluded by the maturity constraint of at least one year but are part of a separate Short Treasury Index. In addition, certain special issues, such as state and local government series bonds (SLGs), as well as U.S. Treasury TIPS, are excluded. STRIPS are excluded from the index because their inclusion would result in double-counting. Securities in the Index roll up to the U.S. Aggregate, U.S. Universal, and Global Aggregate Indices. The U.S. Treasury Index was launched on January 1, 1973.

U.S. Agency: This index is the U.S. Agency component of the U.S. Government/Credit index. Publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government (such as USAID securities). The largest issues are Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB). The index includes both callable and non-callable agency securities.

U.S Corporate – Investment Grade: This index is the Corporate component of the U.S. Credit index. It includes publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.

CMBS (Commercial Mortgage-Backed Securities): This index is the CMBS component of the U.S. Aggregate index. The Bloomberg Barclays CMBS ERISA-Eligible Index is the ERISA-eligible component of the Bloomberg Barclays CMBS Index. This index, which includes investment grade securities that are ERISA eligible under the underwriter’s exemption, is the only CMBS sector that is included in the U.S. Aggregate Index.

MBS (Mortgage-Backed Securities): This index is the U.S. MBS component of the U.S. Aggregate index. The MBS Index covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.

ABS (Asset-Backed Securities): This index is the ABS component of the U.S. Aggregate index. The ABS index has three subsectors: credit and charge cards, autos, and utility. The index includes pass-through, bullet, and controlled amortization structures. The ABS Index includes only the senior class of each ABS issue and the ERISA-eligible B and C tranche. The Manufactured Housing sector was removed as of January 1, 2008, and the Home Equity Loan sector was removed as of October 1, 2009.

Corporate High Yield: The Bloomberg Barclays U.S. High Yield Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baal/BBB+/BBB+ and below using the middle of Moody’s, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

The Bloomberg Barclays Municipal Bond Index is a broad-based, total-return index. The bonds are all investment-grade, tax-exempt, and fixed-rate securities with long-term maturities (greater than 2 years). They are selected from issues larger than $50 million.

The Bloomberg Barclays TIPS Index consists of Treasury Inflation Protected Securities (TIPS). TIPS are securities whose principal is tied to the Consumer Price Index. TIPS pay interest semi-annually, based on the fixed rate applied to the adjusted principal.

Ratings are measured on a scale that ranges from AAA or Aaa (highest) to D or C (lowest). Investment grade investments are those rated from highest down to BBB- or Baa3.