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The Fed, interest rates and bonds

EDITION 21 – 24 JUNE 2013

Key points

> The US Federal Reserve ("Fed") looks on track to start slowing its quantitative easing ("QE") program later this year, but only if the economy continues to improve. More importantly, it's unlikely to raise interest rates any time soon.

> This suggests a 1994-style bond crash remains unlikely for now. However, bond returns are still likely to remain poor as yields gradually rise to more normal levels.

> Shares are vulnerable to sharp rises in bond yields, but they offer much better value relative to bonds.

Introduction

As the US economy continues to recover, it was inevitable that investor focus would shift from the need for more stimulus, which has been the dominant issue over the last few years, to when the US Federal Reserve will actually start to reverse the stimulus. This is important because easy monetary conditions on the back of poor growth and low inflation – first low rates and then QE – have helped underpin a fall in bond yields to record lows. This in turn has underpinned strong returns from sovereign bonds and gains in bond-like high yield investments, notably corporate debt, real estate investment trusts (REITs) and high yield shares, such as banks and telecommunications companies in Australia.

Nervousness about a change in direction from the Fed has been building this year, particularly over the last month following Fed Chairman Bernanke's comments that he is prepared to slow or "taper" the pace of quantitative easing "in the next few meetings". This would likely mean cutting the US$85 billion a month it is buying in government bonds and mortgage-backed securities to around US$60 billion a month.

Fearing this signals a shift towards the start of US monetary tightening, expectations for interest rate hikes in the US have been brought forward a year or so, bond yields have increased sharply and beneficiaries of easy money in the US, such as non-government debt, REITs, emerging market debt and equities, high yield shares and the A$ have all been under pressure. This has happened at a time when not all US economic data has been strong, leading some to fear a premature tightening by the Fed.

So the Fed's latest monetary policy setting meeting was much anticipated for greater clarification around these issues.

The message from the Fed

The basic message from the Fed may be summarised as follows.

First, Chairman Ben Bernanke confirmed that the Board may start to slow the pace of QE later this year. He added that the reduction is likely to be gradual and that QE could end by mid next year. However, he also noted that this is conditional on the economy continuing to improve as the Fed expects, with growth projected to accelerate to 3-3.5% next year. While the immediate reaction in share markets has been negative, taking the lead from confirmation that QE is on track to be phased down, the fact it will only be phased down if the economy continues to improve is likely to be supportive for shares going forward, as this means stronger profits. When it does start to taper, the Fed is likely to prefer a meeting after which it has a press conference where it can explain its actions. This would suggest action will be taken at the September meeting at the earliest.

Second, the pace of QE can still be increased or decreased in the future, depending on how the US economy is performing. In other words, just because the Fed might start to taper in say, September, doesn't mean that all the next moves will automatically be towards a further reduction. In fact, Bernanke appears to have made a steady decline in QE towards ending the program in mid-2014 contingent on expectations being met that the unemployment rate will fall to around 7% by then. For growth-oriented investments, this is effectively what some have called the "Bernanke put", i.e. either the economy and profits improve (supporting share markets) or QE continues. It's very different to the first two rounds of QE that automatically ended in March 2010 and June 2011, only to be followed by significant share market weakness.

Third and most importantly, the Fed reiterated that any decision to slow QE does not mean that interest rate hikes are any closer. In fact, 15 of the 19 Fed meeting participants don't expect the first Fed Funds rate hike until 2015 or later. This is one more than in March. Moreover, the Fed continues to indicate that near zero interest rates will be justified at least as long as unemployment remains above 6.5% and inflation expectations remain low, with Bernanke pointing out that the 6.5% unemployment rate is a threshold, not a trigger. This suggests that the move forward over the last six weeks in money market expectations for the first Fed rate hike from mid-2015 to mid-2014 is premature. Expect rate hike expectations to settle down again and push back into 2015.

Our assessment

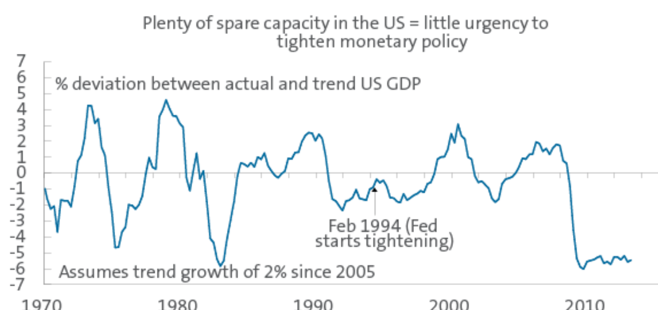
Our assessment is that while the Fed will likely start to slow quantitative easing later this year, this will actually be a good thing because it will only occur because the Fed's mission has been accomplished. In other words, the US economy

can start to be taken off life support. Moreover, by the time this occurs it will be a surprise to no one.

However, as the Fed keeps telling us, it is unlikely to want to rush into raising interest rates, given that:

> Growth is still a long way from booming and is still relatively fragile as the private sector continues to reduce debt ratios. This is evident in bank loans growing at just 3%p.a and fiscal stimulus now being reversed. This is also evident by the mixed tone of recent economic indicators, with a solid housing recovery but soft readings for the ISM and most other manufacturing conditions indices.

> Spare capacity remains immense as evident by a 7.6% official unemployment rate and double-digit labour market underutilisation and a still very wide output gap (i.e. the difference between actual and potential growth), as shown in the next chart.

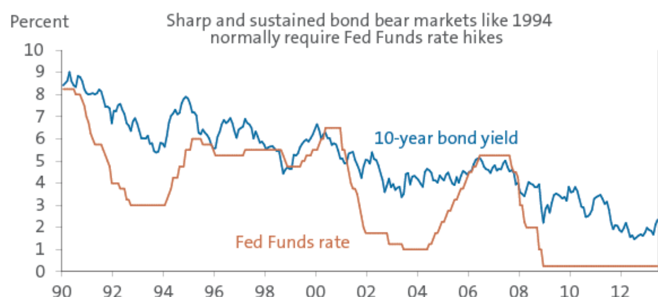


Source: Bloomberg, AMP Capital

> As the labour market continues to strengthen, labour force participation will likely start to bounce back, slowing the fall in the unemployment rate and achievement of the Fed's 6.5% threshold.

> Inflation is low and falling, currently just 1.4%.

So short of a sharp acceleration in the US economy, it's very hard to see the Fed raising interest rates for the next year at least. This is important because the 1994 'bond crash', which saw US 10-year bond yields rise nearly 300 basis points, was triggered and underpinned by an aggressive rise in the US Fed Funds rate (its official short term interest rate). See the next chart.



Source: Bloomberg, AMP Capital

Implications for investors

Despite an initially negative reaction, the message from the Fed remains reasonably market friendly. The pace of quantitative easing will only slow when the economy is stronger and rate hikes are unlikely any time soon.

The bottom line is that at this stage, a 1994-style bond crash still seems unlikely.[1] US interest rates are unlikely to rise any time soon and in Japan, Australia and probably Europe, monetary conditions are still in the process of being eased.

However, we remain cautious of sovereign bonds, given that yields remain well below long term sustainable levels, for which potential nominal GDP growth provides a good guide. See the next table.

Bond yields are well below sustainable levels

	Current 10 year bond yield (%)	Potential long term nominal economic growth (%p.a)
US	2.4%	4.3%
Germany	1.6%	3.3%
UK	2.1%	3.3%
Japan	0.8%	2.3%
Australia	3.6%	5.2%

Source: Bloomberg, AMP Capital

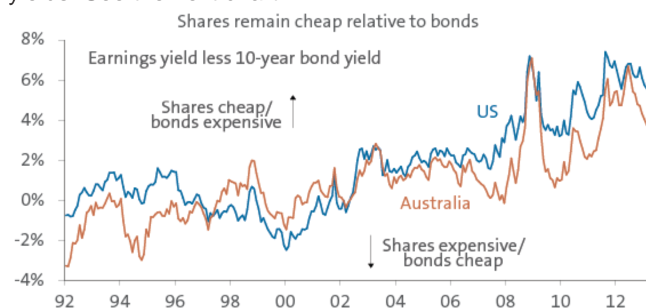
After four years of record inflows, US bond funds are at risk of seeing big outflows as investors start to see lower or poor returns. In fact, they have started to see outflows in the last few weeks and this could have a long way to go if sentiment towards bonds really turns negative. And of course, this in turn will create upward pressure for bond yields.

Finally, periodic bouts of nervousness regarding the Fed will likely continue as the US economy continues to improve.

As a result, we remain of the view that sovereign bond yields will continue to gradually trend higher, resulting in poor returns for bond investors.

Against this backdrop, the chase for yield will likely continue as interest rates will remain low, albeit with perhaps less enthusiasm than seen over the last year. However, returns from assets that have already benefitted immensely from low bond yields like credit and real estate investment trusts will likely slow.

Shares have also benefitted from lower bond yields, although it is worth noting that in relation to US shares, gains have been underpinned by record profits. Moreover, they still trade on relatively high forward earnings yields compared to bond yields. See the next chart.



Source: Bloomberg, AMP Capital

This suggests that earnings yields on shares still offer a reasonable buffer as bond yields normalise, albeit a too rapid or great an increase in bond yields will result in more short term volatility as we have seen over the last month.

One final point to note is that a move towards the end of quantitative easing in the US will further reverse the upward pressure seen on the A$ since 2009. This will be good news for the Australian economy as the stubbornly strong A$ has been a key factor holding the economy back recently. Expect the A$ to fall to around US$0.80.

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[1] See "What's the chance of a bond crash?" Oliver's Insights, Feb 2013.

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