LPL RESEARCH

BOND MARKET PERSPECTIVES

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FEDSPEAK FLATTENER

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KEY TAKEAWAYS

The bond market has almost fully priced in a March 2017 rate hike.

Hawkish comments from Fed speakers have been a big factor in the bond market's increased conviction in a hike.

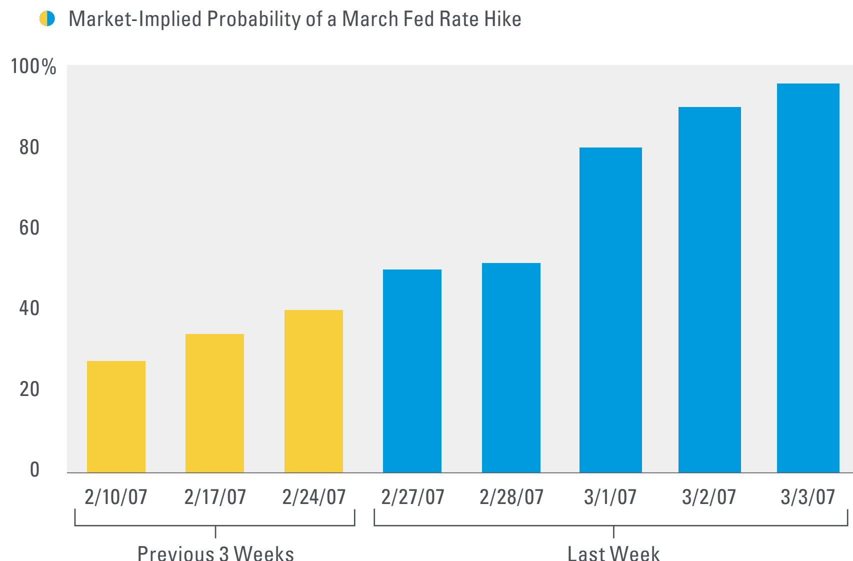
Heightened rate hike expectations have led to a flatter yield curve, which seems to be expressing that the bond market is less optimistic about the economy than the stock market.

The bond market is clearly signaling to the Federal Reserve (Fed) that it expects a rate hike in March, earlier than the market was implying in early 2017. A slew of strong economic data was the main culprit, with the push toward growth-focused (and thereby possibly inflationary) policies from the Trump administration still looming in the background. However, the conviction for a March 2017 rate hike was solidified by hawkish, aggressive rhetoric from Fed speakers last week. The fed funds futures market-implied chances of a March 2017 rate hike soared from just 28% on February 10, 2017 to 94% three weeks later on March 3, 2017. The pickup over last week (February 27, 2017 through March 3, 2017) represented the majority of the move [Figure 1].

THE POWER OF FEDSPEAK

Although the timing was coincidental, we don't believe the move higher in rate hike expectations was a result of President Trump's speech to Congress last Tuesday

1 MARCH 2017 RATE HIKE ODDS HAVE NOTCHED UP CONSIDERABLY



Source: LPL Research, Bloomberg 03/03/17

The market-implied chances of a rate hike are calculated based on pricing of various fed funds futures contracts.

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evening (February 28, 2017). The speech, largely devoid of new information or policy specifics, perhaps soothed markets as it was relatively restrained in delivery, but it is unlikely rate hike expectations would jump so dramatically on that alone.

The main driver of the recent large pickup in rate hike expectations was hawkish Fedspeak from a range of officials, both those considered doves and hawks by the investment community (in chronological order):

- **Dudley (dove):** New York Fed President Dudley had rather pronounced comments that "the case for monetary policy tightening has become a lot more compelling." He also mentioned that the risks to the economic outlook are "tilting to the upside," as presumed fiscal policy from Washington, D.C. is uncertain but will stimulate the economy to some extent. His comments boil down to the fact that although the Fed wants to hike rates gradually, there is growing concern that not moving soon may result in the Fed getting behind the curve, meaning that inflation will have picked up past a desirable level, necessitating more aggressive tightening, which may be detrimental to the economic recovery.
- **Harker (hawk) and Kaplan (moderate hawk)**: Philadelphia Fed President Harker and Dallas Fed President Kaplan maintained their hawkish tones that three rate hikes were appropriate this year and that a rate hike is possible at the Fed's March meeting.
- **Williams (dove)**: San Francisco Fed President Williams noted that the economy was at full employment nationwide and that a rate hike in March was a "serious consideration."
- **Brainard (dove)**: Fed Governor Brainard mentioned her willingness to raise rates "soon."
- **Powell (centrist)**: Fed Governor Powell reiterated the comments of Harker and Kaplan; three rate hikes seem appropriate in 2017, and March is on the table.

HAWKS / DOVES

Hawks are Fed officials who favor prioritizing the low inflation side of the Fed's dual mandate of low inflation and full employment. Doves are Fed officials who are willing to tolerate higher inflation in order to achieve the full employment side of the Fed's dual mandate.

- **Yellen (dove):** Fed Chair Janet Yellen provided markets the most pointed and ultimately important Fedspeak of the week. She said on Friday (March 3, 2017) that a March rate hike "would likely be appropriate" if "employment and inflation [continue] to evolve in line with our expectations." Shorter-maturity rates popped higher on the comments, and March rate hike expectations moved from 92% before her speech was released to 96% immediately after.
- **Fischer (centrist):** Fed Vice Chair Fischer, when asked whether the Fed speakers this week were part of a "conscious effort" to increase rate hike expectations, answered that if so, he was "about to join in," saying he strongly supports the views of the other Fed speakers' hawkish tilts.

YIELD CURVE FLATTENING

The consistency in hawkish Fedspeak pressured shorter-term Treasury yields higher throughout the week. Longer-term yields rose, but not as much, leading to a flattening of the yield curve. A flatter yield curve can usually be interpreted as a sign of lower growth and inflation expectations: investors are at least temporarily willing to buy longer-maturity bonds for the additional yield because they don't think that inflation is an immediate risk. Yield curve steepness has gradually declined since

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mid-February, and events last week (February 27, 2017 through March 3, 2017) have moved the yield curve to its flattest point year to date. Though it has recovered somewhat since, the spread between 2-year and 10-year Treasuries on February 28, 2017 was at its flattest level since November 9, 2016, the day after the election [Figure 2].

Another oft-cited measure of yield curve steepness is the 5-year/30-year. This metric looks at the steepness with less influence of the Fed, which has more of an impact on the 2-year Treasury and shorter-maturity bonds. This metric is approaching the 1% level reached mid-2016, early 2015, and during the recovery from the financial crisis [Figure 3].

These measures of yield curve flattening seem to be indicating that fixed income markets are sending messages that differ from those of equity markets. As equity markets press to successive record highs, fixed income markets are expressing some pessimism that Trump's agenda will be very stimulatory, or perhaps that the agenda itself is at risk of coming to fruition. With fixed income markets more subdued immediately ahead of the Fed's decision, time will tell whether fixed income markets catch up with equity markets on growth expectations, or vice versa. There are other forces at play as well. Due to low global developed market sovereign yields, foreign buyers continue to enter the Treasury market opportunistically when rates move higher. This may also be contributing to the flattening of the yield curve.

WHAT HAPPENS IF THE FED HIKES?

The presumed March rate hike would be the first non-December hike of this tightening cycle. After hiking in December 2015 and 2016, the Fed and the market agree that Fed rate hikes will be coming at a faster pace in 2017. So how will markets

2 YIELD CURVE STEEPNESS HAS BEEN IN A DOWNTREND

Source: LPL Research, Bloomberg 03/03/17

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

Past performance is no guarantee of future results.

3 OTHER STEEPNESS MEASURES NEAR CYCLE LOWS

Source: LPL Research, Bloomberg 03/03/17

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react? The two most recent hikes provided disparate examples. In December 2015, a rate hike contributed to equity market weakness that lasted through January 2016. Importantly, other serious issues were also occurring at that time: economic concerns around China and oil price weakness, which stoked default fears in energy companies and general equity market unease. In December 2016, equity markets shrugged off a Fed rate hike and continued their post-election advances.

CONCLUSION

So which way will markets go this time? Absent any dropoff in economic data, the economy appears to be on solid footing, with no real "problem children" as with the energy sector in 2014–2016. With the fed funds futures market almost fully pricing in the March rate hike already, we don't expect a large-scale move in fixed income markets as a result of a hike. Entering the week prior to the Fed meeting, market-implied chances of a rate hike in December 2015 were just 78%, while entering the week prior to the December 2016 hike they were 100%. A market expecting a hike is less likely to be jarred by one. With roughly one week until the potential March 2017 rate hike, odds at 98% (as of March 7, 2017) are a comforting sign that the bond market may be ready for another rate hike. ■

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DEFINITIONS

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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