FED RAISES Interest Rates

EAGLE | Asset Management
AN AFFILIATE OF CARILLON TOWER ADVISERS

December 19, 2018

KEY POINTS:

- The U.S. Federal Reserve (Fed) raised interest rates, but softened its outlook on rate hikes for 2019.
- Market odds for a rate hike dropped before this meeting as a consequence of recent volatility.
- FOMC continues to say that "some further gradual increases" in interest rates may be appropriate.

As was widely anticipated, the Federal Open Market Committee (FOMC) increased the Fed funds rate by 0.25 percent, marking the ninth rate hike of the current tightening cycle. The FOMC also signaled that two interest rate increases are likely in 2019, as opposed to three. Fed Chairman Jerome Powell stressed that these projections may be adjusted as incoming data shed light on the economy.

In the days leading up to this meeting, market odds for a rate hike had dropped as a consequence of recent market volatility. It is the opinion of Eagle Asset Management's Fixed Income team that the Fed's actions have contributed to this increase in volatility. It is no coincidence that the dearth of global central bank liquidity that surfaced at the beginning of October occurred around the same time as the decline in risk assets. Even though the Fed had been tapering its balance sheet for nearly 15 months, other global central banks' asset purchase programs offset the Fed's actions. Now, global central banks are largely implementing less accommodative monetary policies – at least for the time being.

Just as quantitative easing had a profound impact on the economy and prices for risk assets, it is reasonable to expect quantitative tightening to have a similar but opposite effect. While the Fed has manipulated the Fed funds rate in previous cycles, quantitative easing and quantitative tightening are new tools. No one quite knows how this unwind will play out.

Capital markets have been signaling to the Fed that a pause is in order. The Goldman Sachs Commodity Index is down over 20 percent since the beginning of October. The S&P 500 is down 13 percent. We recently saw inversions in the 5-year and 3-year and 5-year and 2-year U.S. Treasuries – worth noting, although these are not the most systematically important areas of the yield curve.

More worrisome for us are the signs from credit markets: Corporate bond spreads, both investment grade and high yield, have widened to their highest levels in years. We expect employment data to soften if spreads remain at these levels or continue to widen. Doors to the credit market have closed as new issuance has ground to a halt. Multiple deals have been pulled from the market due to what has been cited as unfavorable market conditions. In fact, the high yield market hasn't had a single new bond issuance so far in December. If this trend continues through month end, it will mark the first month without a high yield bond deal since 2008. The month of December 2018 has marked the largest dollar amount of bonds downgraded from A to BBB since 2015. Several large companies are teetering on the brink of being downgraded to junk.

If the Fed maintains its course, we expect this to trend to continue. Credit markets – the fuel for stock buybacks, dividends, and mergers and acquisitions (M&A) – have gone quiet, at least for now.

While the Fed dot plot has two rate increases forecasted in 2019, Eurodollar futures and other market-based indicators point to less than one increase next year. Unless inflation increases materially, we believe the latter seems more likely, and a focus on highly rated bonds will be key over the next year.