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RATE HIKE EXPECTATIONS ON THE MOVE

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KEY TAKEAWAYS

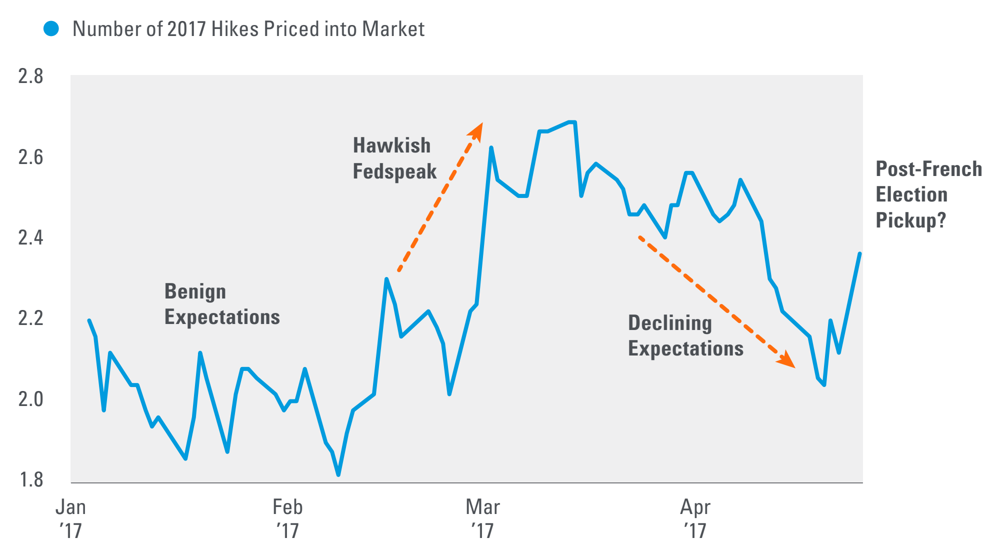
Since the Fed's April 5 release of its March 14–15, 2017 meeting minutes, rate hike expectations for 2017 have dropped materially.

Longer-term rate hike expectations, like those in 2018 and 2019, have also fallen from a month ago.

Falling longer-term Treasury yields, geopolitical conflicts, a lower dollar, and cheaper oil make it more difficult for the Fed to raise rates.

Though Treasury yields bounced off year-to-date lows in the wake of the first round of French elections, all eyes remain on the Federal Reserve (Fed) for direction on future interest rate hikes. Since the Fed released the minutes from its March 14–15, 2017 Federal Open Market Committee (FOMC) meeting, the fed funds futures market has gone from pricing in approximately 1.7 additional rate hikes in 2017 (not including the March hike) down to approximately 1.4 as of Monday, April 24 [Figure 1]. Increased geopolitical risk, delays in pro-growth policies from the new administration, and weaker than expected employment data influenced the decline in rate hike expectations. Combine these factors with the pressure on the dollar due to comments from President Trump and lower crude oil prices, and it becomes easy to see why the fixed income market has notched down its expectations for fed rate hikes throughout 2017.

1 RATE HIKE EXPECTATIONS FOR 2017 HAVE FALLEN OVER THE PAST MONTH



Source: LPL Research, Bloomberg 04/24/17

Market implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate hike expectations may not develop as predicted.

DECLINING YIELDS LEAD TO LOWER RATE HIKE EXPECTATIONS

On April 18, 2017, the 10-year Treasury yield hit a year-to-date low of 2.18%, before bouncing higher to close at 2.27% on April 24. Since January 2017, the 10-year Treasury yield has fluctuated in a yield range, defined by a 2.62% yield on the high end to a 2.18% yield on the low end, but much of that time has been spent in a narrower 2.30–2.65% yield range. Many factors, including fundamentals, policy factors, and technicals continue to weigh heavily on Fed decisions regarding future rate hikes.

- **Mixed messages sent by soft and hard domestic economic data.** Consumer and business confidence are high and rising; however, a weaker-than-expected employment report, though not indicative of a recession, provided additional support to Treasuries. Improving jobs data could quickly remove this support and push rate hike expectations higher.
- **Delays in pro-growth policies.** As the Republicans failed to come to an agreement over repealing and replacing the Affordable Care Act, some investors began losing confidence that the pro-growth agenda will materialize soon and, as a result, shifted from risk assets into Treasuries. Should the administration surprise the market and achieve comprehensive tax reform this fall, defensive investments like Treasuries may become less desirable and rate hike expectations may increase.
- **Geopolitical risk in Syria and North Korea.** The launch of a military operation in Syria on April 6 has investors on edge due to the possibility of a protracted engagement. In addition, recent comments from the new administration related to North Korea have led to a risk-off trade that has helped support Treasuries. Any stability or easing of geopolitical risk in these regions could drive a rotation out of Treasuries and back into risk-on assets, potentially raising rate hike expectations as well.
- **Despite stabilization overseas, the Fed will focus on U.S. economic data.** Prior to April 23, 2017—the first round of the French presidential election—markets were on edge, with anti-EU candidates poised to do well. This nervousness was short lived as the markets rallied on news that the heavily favored centrist candidate, Emmanuel Macron, was slated to run against the Front National candidate Marine Le Pen in the second and final round of voting in France scheduled for May 7, 2017. Although European markets are performing well, recent U.S. data disappointments, including misses on payroll and gross domestic product (GDP), are capping U.S. Treasury yields. If economic data misses continue to escalate, this could pressure the Fed to remain on the sidelines and not raise rates as aggressively.
- **Dollar headwinds.** A stronger dollar typically weakens the competitiveness of U.S. exports as products become more expensive overseas. This leads to a decline in demand for U.S. products overseas and in turn suppresses commodity prices and inflation. Lower inflation makes it difficult for the Fed to raise rates, and this factor is being priced into the rate hike expectations, causing them to decline.
- **Technical factors.** Two weeks ago, intermediate Treasury prices broke through a key resistance level, suggesting that price strength may continue, and targeting the 2.18% yield level. If the 10-year breaks below the 2.18% level, this may open the door for the 10-year yield to drop to 2.00%, though this scenario looks less likely now that rates have pushed higher. We do not believe that technical analysis, the analysis of price patterns to determine future price movements, is a primary driver of bond yields over long periods. In our view, technical analysis falls behind Fed policy, the rate of inflation, and the pace of economic growth. However, over short periods, technical indicators are closely followed and can have an influence over the near-term direction of Fed rate hike probabilities.

The above forces have conspired to drive down rate hike expectations in 2017 and beyond. The market is now pricing in a significantly slower pace of hikes, pulling the market even farther from Fed expectations [Figure 2] then it was a month ago.

CONCLUSION

Market-based rate hike expectations for the June Fed meeting remain elevated at 73%. However, longer-term expectations for hikes have fallen in recent weeks, as market participants have priced in additional geopolitical risk, the dollar has weakened, and President Trump's pro-growth policy agenda has been delayed. Our base case remains that the Fed will implement one to two additional rate hikes in 2017, and we continue to believe the 10-year Treasury will end the year in the 2.25–2.75% range, with the potential for as high as 3% if meaningful fiscal stimulus is enacted.* ■

2 THE FED AND MARKET VIEWS ABOUT RATE HIKES ARE DIVERGING

		Additional Hikes This Year	Total Hikes 2018	Total Hikes 2019
Fed Median Dot Plot		2	3	3.5
Fed Funds Futures Market Implied	3/13/17	1.68	2.18	1.28
	4/24/17	1.38	1.32	0.88

Source: LPL Research, Bloomberg 04/24/17

The Fed's "Dot Plot" is the predictions of the fed funds rate by Federal Open Market Committee (FOMC) participants.

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*We expect the 10-year Treasury yield to end 2017 in its current range of 2.25 – 2.75%, with a potential for 3%. Scenario analysis based on this potential interest rate range and the duration of the index indicates low-to-mid single digit returns for the Bloomberg Barclays Aggregate Bond Index.

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

DEFINITIONS

The Federal Open Market Committee (FOMC) is the branch of the Federal Reserve Board that determines the direction of monetary policy. The eleven-person FOMC is composed of the seven-member board of governors, and the five Federal Reserve Bank presidents.

The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

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