HIGHLAND

MARKET BRIEF
JUNE 2017

FED POLICY: ACT II, SCENE I

On June 14th, the Federal Open Market Committee ("Fed") voted to raise the federal funds rate another 0.25% to a range of 1.00-1.25%. This is the fourth interest rate hike since late 2015, after the Fed kept rates near zero for years following the Global Financial Crisis. The Fed's Dot Plot, which is a tool it utilizes to inform investors of its expectations for future rate hikes, illustrated one more hike before year end, and the Fed confirmed that it will continue to normalize interest rate policy at a gradual pace. Currently, the market is pricing in a less than 50% probability of another rate hike this year.

There had been some discussion about whether the sluggish growth in the 1st quarter as well as the latest payroll report were signs of further deceleration in the economy. Chairperson Yellen noted in the Q&A session that preceded the meeting that the Committee believed the 1st quarter slowdown in the economy was transitory, as evidenced by more recent economic data. Initial unemployment claims, which are leading indicators of stress, are at the lowest levels of the current economic cycle. The unemployment rate has declined to its lowest level since 2001, while the underemployment rate has declined from 12.1% to 8.4% over the last three years. Finally, the Atlanta Fed's GDPNOW model forecasts GDP to accelerate to 3.2% in the 2nd quarter. If you combine this number with the 1st quarter, then the economy will have grown 2.2%, which is equal to the 5-year growth rate. Yellen also downplayed recent evidence of declining inflation levels, citing the "noisy" nature of the data.

The dialogue with monetary policy continues to shift from interest rate policy toward the Fed's balance sheet. The balance sheet ballooned due to the Fed's extraordinary accommodative measures of purchasing U.S. treasuries and agency mortgage-backed securities. The Fed is very cautiously approaching the reduction of its balance sheet, with the Committee proposing a gradual program that will allow securities to mature and roll off the portfolio (rather than instituting outright sales). In the Fed's communication, they announced monthly reduction caps of $6 billion for treasuries and $4 billion for agency debt and mortgage-backed securities, and these caps should grow to $30 billion and $20 billion, respectively. Chairperson Yellen did not indicate any specific goals regarding total reductions in the balance sheet from the current level of $4.5 trillion. Instead, she communicated her expectation that the balance sheet would be scaled back "to a level appreciably below that seen in recent years but larger than before the financial crisis." This is a critical step that will lower long-term inflationary pressures while also leaving the banking system well equipped to handle future stress periods. With full details on how the Fed will reduce its balance sheet, this should delay the next rate hike until year end, as implementing the balance sheet reduction takes priority in the immediate term.

There remains some angst as to whether yields will rise as the balance sheet is unwound. Highland believes that multiple forces will drive changes in the yield curve beyond

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any influences from tapering the balance sheet. It is typical for the yield curve to flatten in periods in which the Fed is raising rates. The spread between 10-year and 2-year treasuries—a barometer for the steepness in the yield curve—has declined 42 basis points since the first interest rate hike in December 2015. The yield curve flattened on average 175 basis points over the last three rate hiking cycles. In addition, demand from foreign buyers should have the biggest impact on the steepness of the yield curve. The European Central Bank ("ECB") and the Bank of Japan are still actively engaging in asset purchases and holding yields lower. Year to date, central banks around the world have purchased more than $1 trillion of assets. Historically, the movement in the U.S. yield curve has driven yields in other major developed countries. However, this changed when the ECB moved to a negative interest rate policy along with its own asset purchase program. The current yield on German and Japanese 10-year bonds is 0.23% and 0.06%, respectively; yields on 10-year U.S. treasuries are substantially higher at 2.1%. This is a massive yield spread and will keep a ceiling on how high rates in the U.S. will move. For U.S. yields to move higher, European and Japanese yields will need to be the catalyst. Therefore, investors will be closely scrutinizing the actions of these central banks for clues. In the latest ECB policy meeting, President Mario Draghi noted that the committee will not reduce short-term rates any further, but the asset purchase program will continue for the foreseeable future. The ECB even lowered its inflation forecast to give the Committee more cover to extend its asset purchase program.

Lastly, if U.S. yields were to move higher, then there would be a significant demand from pensions, insurance companies, and banks that would keep an upper limit on yields. Furthermore, the dollar's status as the world's reserve currency should result in a constant demand for U.S. treasuries. Thus, the only major factor left to drive yields upward is accelerating inflation. Based on current policy stalemate, it does not appear that this will be a near-term force. While fiscal policy could play a role in higher inflation, any large infrastructure or significant tax reform would take years to impact the economy. In addition, it appears that some of the populist wave has subsided. This is evidenced by the Trump administration's decision not to label China a currency manipulator, positive revisions to the North Atlantic Free Trade Agreement, and the results from the French and Dutch elections. Finally, long-term inflation is driven by demographics, which currently present more headwinds, leading to lower expected growth and inflation going forward. These factors should anchor the long-end of the yield curve as the Fed raises short-term rates, resulting in a flatter yield curve.