Strategy
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Timing of Higher Interest Rates, a New Fed Conundrum

Contacts

Lance Pan, CFA®
Director of Investment Research and Strategy
Main: 617.630.8100
Research: 617.244.9466
lpan@capitaladvisors.com

Abstract
Lower oil prices and easier central bank policies outside the U.S. led the market to question the Fed's timetable for raising interest rates. While both disinflationary and expansionary forces are present, financial markets appear to be focusing on the former, as the latter is still materializing. The net effect may allow the Fed to stay on schedule to raise rates in the second half of 2015. Short-term investors should remain patient through this transitory period.

Introduction
The Federal Reserve's extraordinary monetary policy accommodations over the last six years resulted in a near zero fed funds rate and growth of its balance sheet by 350% to $4.5 trillion. Today, however, as housing and labor conditions continue to improve and the economy regains its solid footing, the markets and the Fed are looking forward to a new chapter of monetary policy normalization signaled by a higher fed funds rate in the near future. However, rapidly declining energy prices, deflationary concerns outside the U.S., and central banks' decisions to devalue currencies resulted in high market volatility and doubt in the timing for higher short-term rates in 2015 by the Fed's consensus forecast.

In the short-term fixed income market, yields rose steadily last Fall in anticipation of the Fed's pending move. The two-year Treasury note yield rose nearly 0.30% to 0.68% between October and December. In January, however, it tumbled 0.20% to 0.48% after Fed officials added that they could be patient when raising interest rates. Understanding the confluence of factors influencing Fed decisions may help investors stay prepared for more short-term volatility. We will attempt to explain both the positive and negative effects from these recent events on the economy and gain a glimpse into the timing of the Fed's next move.

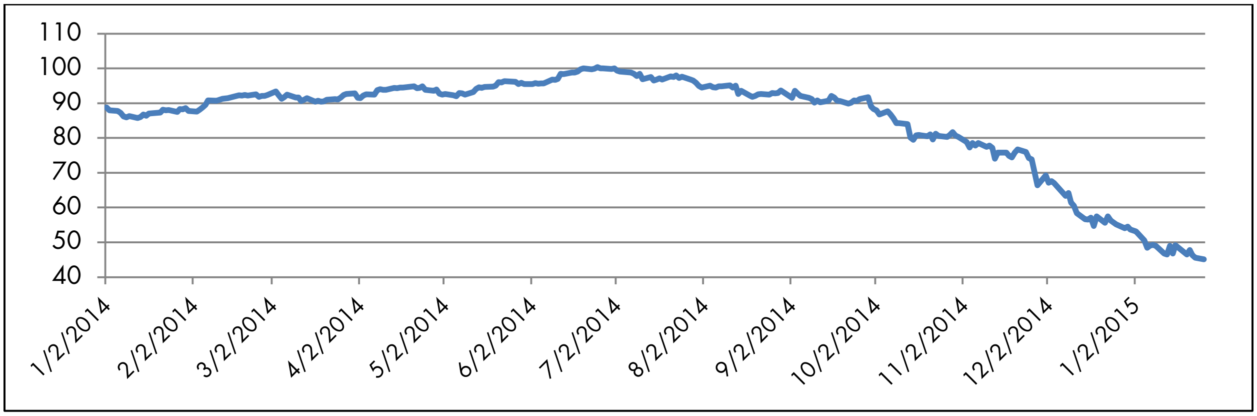
Lower Oil Price - Cause and Effect
The price of crude oil started its decline last June from over $100 per barrel levels. The sell-off picked up speed in November after main petroleum producing nations that control 40% of the world's supplies failed to reach an agreement on production curbs. It dropped below $50 per barrel after Saudi Arabia decided not to cut production to prop up oil markets.

Supply & Demand: The rapid decline stemmed from both supply and demand issues that may persist into the foreseeable future. On the production side, the oil boom in the U.S. driven by hydraulic fracturing, or fracking, vastly increased field production from an average of five million barrels a day in 2008 to nine million barrels in October 2014[1].

[1] U.S. Energy Information Agency, Petroleum and Other Liquids, U.S, Field Production of Crude Oil. http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=pet&s=mcrfpus2&f=m

The concerns of losing market share by major oil producing nations exacerbated the weakness in price. While recent declines may curb new drilling, the excess capacity will be slow to diminish due to improved technology that increases well output.

Figure 1: New York Mercantile Exchange Oil Futures Price



Source: Generic 1-month CL contract price on the NYM Exchange, Bloomberg

On the demand side, a lower oil price is symptomatic of global economic weakness that has reduced demand for energy. The Eurozone and Japan are struggling to avoid reentry into recession, while growth in China, another big energy consumer, dropped below 7.5% in 2014, its slowest pace in 25 years.

Stimulative or Disinflationary: Generally speaking, lower oil prices stimulate economic activity as they improve real purchasing power, boost consumer confidence, and encourage personal and business spending. However, the recent rapid decline stoked concerns that the hit to oil producing companies may lead to job losses, lower capital spending, and may have a negative impact on the wider economy. Potential political instability in major non-OPEC oil producing nations such as Russia, Nigeria, Iraq and Libya may cause further volatility in the financial markets. How the Fed counter-weighs these factors may ultimately influence the timing of its first rate move.

The minutes of the December 2014 Federal Open Market Committee (FOMC) meeting mentioned the declining price of oil a total of 19 times. The Committee's main takeaway was the price's effect on lowering inflation expectations, which may allow the central bank to be more patient with its normalization process. On the other hand, the Committee was clear that "the net effect of lower oil prices on U.S. economic activity was anticipated to be positive[2]."

Short-term Negative, Medium-term Positive: We think the impact of oil on Fed policy will be transitory. In the short-term, the market's bias may be to the downside, as lower energy prices reduce inflationary pressure and allow the Fed to take a wait-and-see stance. However, concerns with reduced capital spending and losses of oil related jobs may be overstated since the oil & gas sector's direct share of non-residential capital spending accounts for only 11% of total non-residential investment. Additionally, jobs in the oil & gas sector account for only 0.4% of total U.S. employment and 2% of the new jobs in the last five years[3]. On the other hand, the benefits of cheap oil to the economy probably will not be evident until statistics for the first quarter of 2015 are released. In short, the jury is still out if a lower oil price moves up or pushes back the Fed's timetable.

[2] Minutes of the Federal Open Market Committee, December 16-17, 2014, http://www.federalreserve.gov/monetarypolicy/fomcminutes20141217.htm

[3] BCA Research, Oil on Troubled Waters, January 19, 2015.

Global Deflation and Central Bank QE

Global deflationary forces may be a more meaningful factor in the Fed's rate decision, but even there, the net outcome is not easily discernible.

QE Moves by the ECB and BOJ: On January 22, the European Central Bank (ECB) announced a plan to buy €60 billion per month in government, asset-backed and covered bonds worth about €1.1 trillion through September 2016 to help with Europe's fragile recovery. The historic, Fed-style quantitative easing (QE) came after the ECB's earlier unconventional measures failed to lift the Eurozone out of a deflationary spiral. Across the board, yields on Eurozone government bonds declined as traders rushed before the ECB in snatching up eligible securities. The euro declined against the U.S. dollar further to $1.12, or 19% lower than $1.38 last June.

The ECB was not alone in this new round of QE. The Bank of Japan (BOJ), in the latest attempt to push the country's inflation rate above zero, ratcheted up its ongoing QE program last October, planning to inject another ¥80 trillion a year in the financial system, up from the previous ¥30 trillion a year.

Central Banks' Currency Battles: In defense of its currency against the expected euro devaluation from the ECB's QE, the Swiss National Bank (SNB) scrapped a three-year-old cap to keep the Swiss franc at 1.20 per euro. The SNB, along with central banks in Sweden, Norway, Canada, India, and Singapore lowered their benchmark rates within two weeks of each other. Some central banks, notably those close to the Eurozone, may have felt pressure from the euro devaluation. Others, such as India, Canada and Singapore, cited growth concerns and deflationary pressure from the decreasing price of oil. The People's Bank of China, which unexpectedly dropped its benchmark rates late last year, is widely expected to cut rates again in 2015. The new round of monetary easing by central banks left the Fed and the Bank of England the only standouts among developed economies with a tightening bias.

Fed Watchers' Quandary: The new round of monetary easing presents an interesting quandary for Fed watchers. Before the ECB's move, the Fed noted that subdued growth globally is "an important source of downside risks to domestic real activity and employment." The ECB's more-aggressive-than-expected QE policy should be a step in the right direction in combating this downside risk to U.S. growth. Together with easier monetary policies in Japan and the rest of the world, the ECB may provide the much needed assurance for the Fed to stay on or even move its timetable up if deflationary pressure subsides in the coming months.

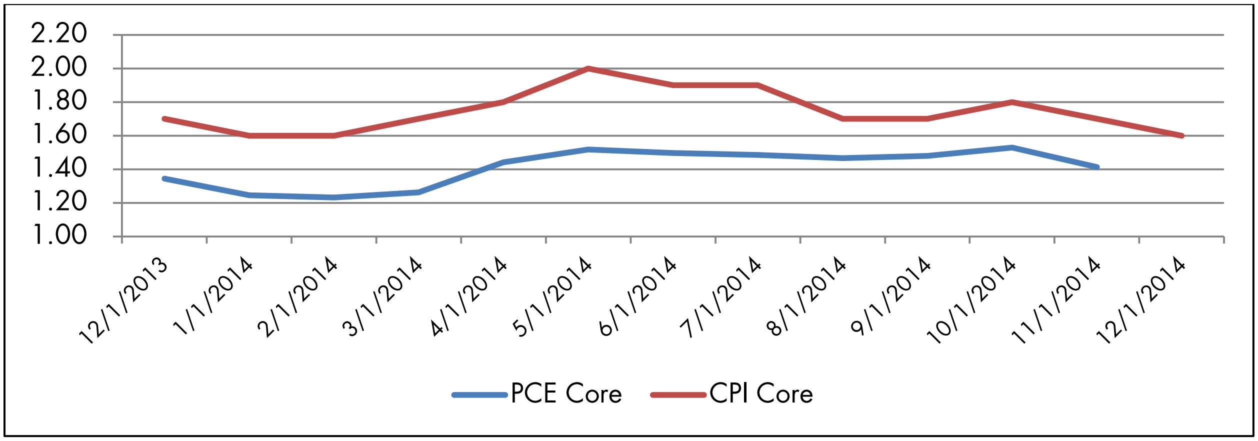
On the other hand, easier monetary policies overseas will further strengthen the U.S. dollar against its major trading partners. The dollar already gained 15% against the basket of major currencies in 2014. A stronger dollar worsens corporate profit erosion of U.S. based multinational corporations, leading to slower growth prospects as exports account for roughly 15% of U.S. GDP. A stronger dollar also puts downward pressure on inflation expectations as future goods and services become more valuable. This may result in lowering inflation even further below the Fed's targeted 2% self-imposed condition for higher short-term rates.

QE Efficacy Is Key: On balance, we believe the net effect of recent actions by central banks on the Fed's timetable may hinge on the efficacy of such programs. Should the programs prove successful, an improved economic outlook in the Eurozone and Japan may benefit the U.S. more than the loss of trade from dollar appreciation. If the programs fail to the reinvigorate their respective economies, the Fed may be more inclined to focus on fighting disinflationary forces rather than begin to raise rates.

The Fed's Timetable and Market Expectations

Allow us to step back and revisit the Fed's current timetable towards higher rates. The December 2014 FOMC minutes provided the Committee's forward guidance with language that "it can be patient in beginning to normalize the stance of monetary policy". It further indicated that the current 0% to 0.25% target range will remain for at least the next two Fed meetings as long as the "projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well anchored."

Figure 2: Core CPI and PCE Indicators Year-over-Year



Source: Bloomberg

Inflation and Inflation Expectations: Figure 2 shows major inflation indicators for the past 12 months. The year-over-year Core Consumer Price Index briefly touched 2% in May 2014 and has since declined to 1.6% in December 2014. The Core PCE Index, or personal consumption expenditures excluding food and energy prices, the preferred measure of inflation by the Fed, has been significantly less than 2% for the past year.

As of December 2014, the Federal Reserve's economic projections put the Core PCE Index at 1.7% to 2.0% at the end of 2016. The mean economist projection polled by Bloomberg puts the same index at 1.90% at year-end 2016. These projections coincide with the condition of a 1-to-2 year inflation outlook of 2% before the Fed considers higher rates.

Forecasts of First Rate Move: As of the December FOMC meeting, the Fed's dot plot puts the mean forecast by the Committee's decision makers at 1.125%, presumably in a range of 1.00-1.25%, suggesting four rate hikes in 25 basis-point increments. This implies that the first move will occur at *the July 28-29 FOMC meeting*. The next dot plot will be released on March 8, 2015.

The fed funds futures market as of January 26, 2015 suggests the first rate hike (greater than 50% probability) will occur at *the October 27-28 meeting*, or two meetings after Fed officials' implied timetable. A third projection comes from the mean economist forecast polled by Bloomberg, which puts the upper bound of the fed funds rate at 1.00% in December 2015, implying *the September 16-17 meeting* will be the starting point to higher rates.

A Disparity of Two FOMC Meetings: After assessing these projections, it appears that the consensus view from the Fed and financial markets continues to favor the start of a higher fed funds rate sometime in the second half of 2015. Their projections are set apart by two FOMC meetings between July and October. Taking a longer-term interest rate cycle view, the timing differences become less significant. A caveat to this tight band may come from recent financial market volatility, should it become a systemic risk concern.

Financial Market Volatility

Market volatility picked up noticeably in recent weeks. Aside from oil and central bank QE, economic and geopolitical developments out of Russia, Greece's general election, and disappointing corporate earnings all contributed to market uncertainty. If the stability of the financial system is threatened by precipitous declines in asset prices, the perception remains among market observers that the Fed may need to stabilize the market and delay its timetable.

While the Fed cannot afford to ignore such issues, Janet Yellen, the Fed Chair, has been clear lately that she is willing to look past short-term market fluctuations and focus instead on more medium-term economic prospects. This view was further validated in the January 27-28 FOMC statement. Short-term volatility does not seem to present systemic risk to the financial system after recent balance sheet repairs and capital strengthening by major financial institutions.

Portfolio Implications and Strategies

Lower Yields Convey Disinflationary Concerns: Fixed income markets clearly interpret the recent drop in oil prices and global QE as disinflationary. Yield on 10-year U.S. Treasury note fell to 1.80%, compared to a 3-month high of 2.39%. The level is still 1.40% lower than the comparable German government bond, suggesting further room to decline as foreign investors seek gains from a higher-yielding safe asset and a strengthening currency.

In the short-duration part of the market, the yield on the two-year Treasury stands at 0.47% after the January 27-28 FOMC meeting, from its widest point of 0.74% over the last three months. As benchmark Treasuries rallied, credit spreads marched steadily higher due to lackluster corporate earnings and higher market volatility. The spread on the 1 to 3 Year Merrill Lynch Corporate A-rated and Higher Index widened 22 basis points since last July to 0.60%.

Positive Impact Takes Time to Develop: We think the movement of rates is consistent with past market-moving events. The decline in energy prices and easy monetary policies by non-U.S. central banks are making a bigger, more immediate, impact on capital movement than the underlying economy. This means that deflationary concerns and lower rates may dominate market sentiment in the short-term, while their positive effect on the economy and higher rates may take time to develop.

Patience is a Virtue: Short-term fixed income markets may continue to face the challenges of the low yield environment and lack of high quality investments. The situation may not improve until the coming spring, when stimulative effects from lower energy prices start to show and the ECB's QE program reaps early benefits. While the exact timing of the Fed's next rate move remains unknown, the second half of 2015 continues to be the most likely outcome. The January 27-28 FOMC statement removed the earlier "considerable period" language; nevertheless, one should not ignore potential systemic shock to financial markets, although such risk remains remote today.

We advise short-term cash investors to remain patient through this transitory period and to not become overly aggressive in duration extension. Maintaining adequate portfolio liquidity is essential during market uncertainties. Resilient economic conditions continue to support non-bank corporate bond issuers, especially given their recent cheapening up relative to Treasuries. Another viable option may be high quality, supranational and quasi-government issues, such as KfW and European Investment Bank, if risk tolerance allows. Such issues may increase in value due to the steady price support from the ECB's QE program.

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Capital Advisors Group, Inc.
29 Crafts Street, Suite 270, Newton, MA 02458
Tel: 617.630.8100 ~ Fax: 617.630.0023
www.capitaladvisors.com
info@capitaladvisors.com