What happens when ‘the Fed yields’?

By Editorial Staff *Thu, May 28, 2015*

'We would prefer to see the Fed depart from its zero interest rate policy (ZIRP) sooner rather than later,' say analysts at BlackRock Investment Institute.

“The U.S. labor market is strengthening, inflation appears to have troughed and financial markets are looking frothy. What happens when the Federal Reserve (Fed) finally yields to this reality and raises short-term interest rates?”

So begins a **whitepaper** published this month by the BlackRock Investment Institute, entitled “When the Fed Yields: Dynamic as and Impact of U.S. Rate Rise.” It focuses on a topic of vital interest to the retirement industry, today and for years to come.

The conclusions reached by the BlackRock analysts are summarized below:

- We expect the Fed to raise short-term interest rates in 2015—but probably not before September. Technological advances are set to keep dampening wage growth and inflation, reducing the need for the Fed to raise short-term rates as quickly and as high as in past tightening cycles.
- The longer the Fed waits, the greater the risk of asset price bubbles—and subsequent crashes. Years of easy money have inflated asset valuations and encouraged look-alike yield-seeking trades. We would prefer to see the Fed depart from its zero interest rate policy (ZIRP) sooner rather than later.
- A glut of excess bank reserves and the rise of non-bank financing mean the Fed’s traditional tools for targeting short-term rates have lost their potency. Overnight reverse repurchase agreements are part of the new playbook. We expect the Fed’s plan for ending zero rates to work, but do not rule out hiccups.
- The impact of any U.S. rate hikes on long-maturity bonds is crucial. We suspect the Fed would prefer to see a gentle upward parallel shift in the yield curve, yet it has only a limited ability to influence longer-term rates. We detail how the absence of a steady buyer in the U.S. Treasury market will start to be felt in 2016.
- QE has created asset shortages. This is feeding an appetite for lower-quality bonds, bond-like equities, real estate and private equity. Leverage is rising. The longer this lasts, the riskier. A sell-off triggered by an unwinding of leverage and magnified by poor liquidity could sink many boats. Think of it as a fruit market. A couple of people are buying up all the apples every day, irrespective of price. Other shoppers rush to buy pears, oranges and guavas to meet their vitamin C needs. Prices rise to record levels. Then one day the apple buyers disappear. The result: a rapid resetting of prices.
- We see the yield curve flattening a bit more over time due to strong investor demand

for long-term bonds. Demand for high-quality liquid fixed income assets from regulated asset owners alone (think insurers and central banks) is set to outstrip net issuance to the tune of $3.5 trillion in 2015 and $2.3 trillion next year.

- The forces anchoring bond yields lower are here to stay—and their effects could last longer than people think. Yet yields may have fallen too far. Bonds today offer little reward for the risk of even modestly higher interest rates or inflation. A less predictable Fed, rising bond and equity correlations and a rebound in eurozone growth could trigger yield spikes.
- Asset markets show rising correlations and low return for risk, our quantitative research suggests. We see correlations rising further as the Fed raises rates. We are now entering a period when both bonds and stocks could decline together. Poor trading liquidity could temporarily magnify any moves.
- Overseas demand should underpin overall demand for U.S. fixed income, especially given negative nominal yields in much of Europe. Credit spreads look attractive—on a relative basis. U.S. inflation-linked debt should deliver better returns than nominal government bonds in the long run, we think, even if inflation only rises moderately.
- Low-beta global equity sectors such as utilities and consumer staples have become bond proxies and look to be the biggest losers when U.S. yields rise. Cyclical sectors such as financials, technology and energy are potential winners.
- Angst about Fed rate rises, a rising U.S. dollar and poor liquidity could roil emerging markets (EM). Yet EM dollar debt looks attractive given a global dearth of high-yielding assets. EM equities look cheap, but many companies are poor stewards of capital. We generally like economies with strong reform momentum.