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ASSET MANAGEMENT

5 Questions With… *Leo Dierckman and Michael Richman*

How to Play a Powell-Led Fed

Leo Dierckmann and Michael Richman, portfolio managers for the OIA Taxable Fixed Income strategies, discuss what they expect from Janet Yellen's FOMC swan song in December, what Fed policy may look like under Jerome Powell and how the firm is positioning taxable bond portfolios for 2018.

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The Federal Reserve will come under new leadership in 2018 as Chair Janet Yellen heads for retirement. The move comes at a time when central bankers are reducing a $4.5 trillion balance sheet and normalizing short-term interest rates that have hovered near zero since 2006.

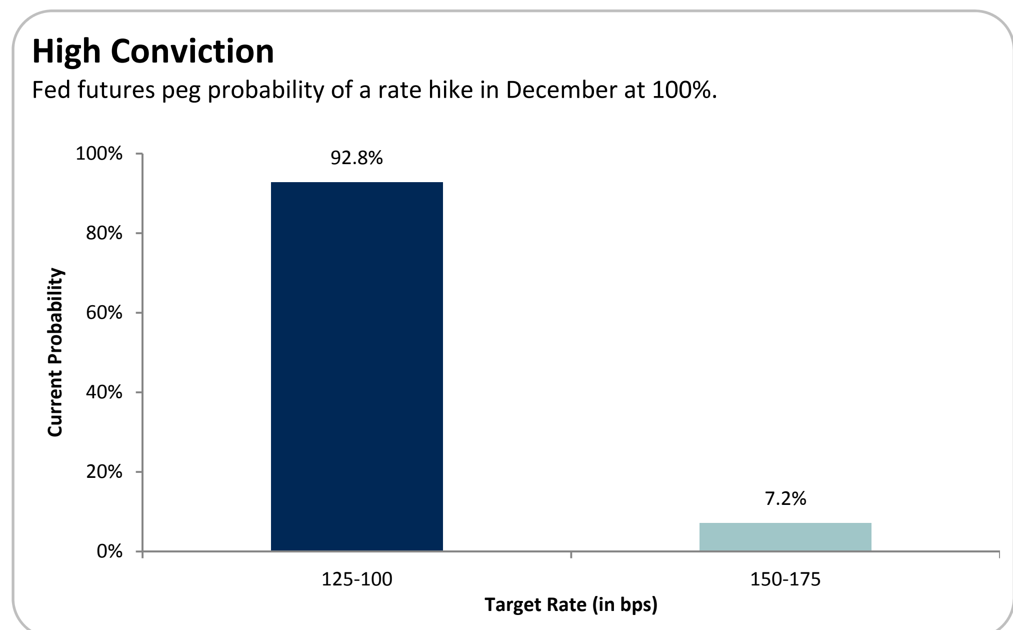
The makeup of the Federal Open Market Committee will also change significantly with four vacancies for the president to fill to round out the Board of Governors. Meanwhile, the Fed is expected to raise rates at its December meeting—its third interest-rate hike in the last year—as economic expansion continues to take hold and more unemployed Americans are going back to work.

In the following interview, Leo and Michael, who manage the OIM Corporate Core Plus strategy—recently named to Informa's PSN Top Guns list for the third straight quarter—will preview the upcoming FOMC meeting and provide insight on what they think Powell's Fed will look like. They will also discuss the potential implications of Fed tightening for today's bond investors, risks to watch out for in 2018 and where they're uncovering attractive opportunities in the taxable bond market.*

1

Fed futures suggest that there is a 100% probability that the Fed will raise interest rates in December. What are the economic underpinnings of such high conviction? What are your views on short-term rates heading into 2018?

Economic data continues to read well. Nonfarm payrolls have rebounded after a temporary dip caused by a series of hurricanes. The unemployment rate continues to drop. The job numbers continue to be strong and that's why we think the Fed is going raise rates again in December. Meanwhile, we're also seeing increased vehicle sales, higher consumer confidence and record-highs in the stock market. In addition, the bond market has been relatively stable. The Fed is taking all of these developments into consideration, perhaps with a greater emphasis on employment data. Right now, the Fed is telegraphing another three rate hikes in 2018.

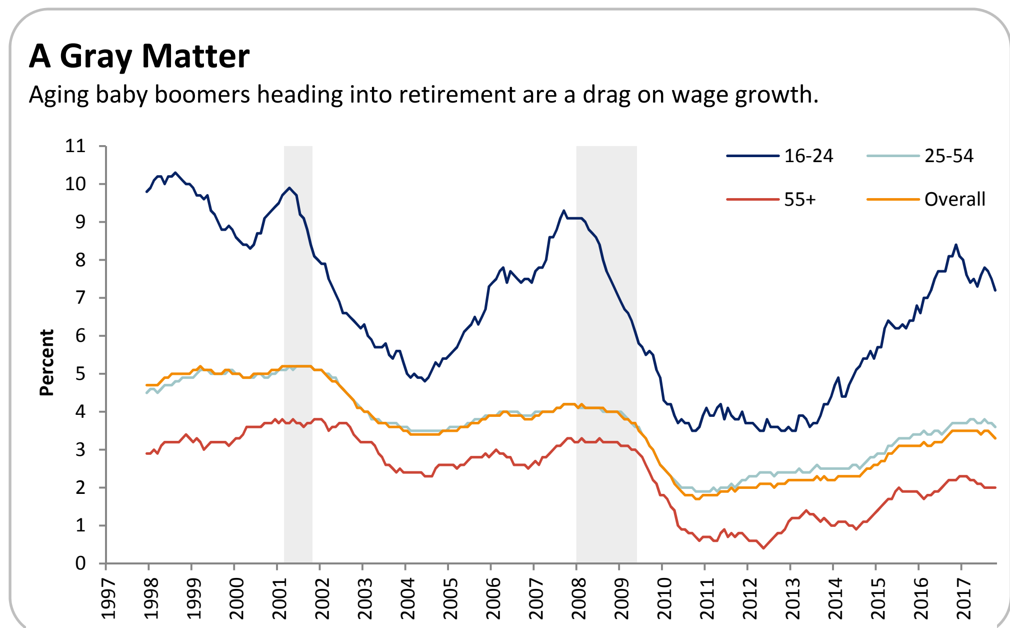


Source: CME Group

2

What about the lack of significant inflation? Wage growth?

Pay increases are not flowing through to overall wage growth due to significant demographic changes. We're seeing extremely low unemployment without real wage inflation—similar to Japan. Still, there are pockets of wage growth in U.S. service sectors among lower-level employees earning $8 to $15 an hour. We have a tight labor market and those hourly wages are starting to move up. That's why the average income in the United States has finally climbed back to 2007 levels at about $59,000. We think income inequality is improving as lower-wage workers continue to receive pay increases and demand for these employees grows. However, that growth is being offset by the 10,000 baby boomers retiring every day. Those people are either not being replaced or they're being replaced by lower-wage workers. And it's obscuring overall wage growth.



Source:Federal Reserve Bank of Atlanta, Bloomberg

3 *What impact will incoming Fed Chairman Jerome "Jay" Powell have on monetary policy and the bond market? What will you be watching for in the commentary coming out of the FOMC in December?*

We like Jay Powell because we think he will continue what Yellen started. He is cut from the same cloth as Yellen so we see him as a dove. However, he might be a little looser on bank regulation. A lot is still up in the air right now. Let's wait to hear from him directly before we paint him into a corner. So far, we haven't seen any market reaction to his nomination. That's good news because we don't want any surprises.

The bigger story is the rebuilding of the FOMC and who will serve as Powell's closest advisors. There's going to be tremendous turnover. There are 19 board members at the FOMC, including seven governors and 12 regional presidents. There is the New York Fed president and then four additional voters from those 12 regions. Right now, the number of vacancies at the Fed is unprecedented. Further, the Trump administration has significant power to reshape the FOMC through personnel decisions and you could see Powell pushing back.

The December FOMC announcement and press conference—along with all future Fed meetings—will garner a lot of attention from equity and fixed-income market participants. We'll be looking for message consistency. Yellen has never dissented since joining the FOMC. And while we view her as a dove, maybe she's not as dovish as we think. Perhaps she's moved too fast on interest rates already. Maybe that explains why we don't have a 2% core PCE.

4

How are you positioning the portfolio in response to tighter monetary policy, an unwinding of the Fed's balance sheet and accelerating growth?

We continue to think interest rates are going to drift higher. But we're not worried about a sharp rise in rates. At the same time, we're not concerned about wages jumping higher either although we see them rising at a modest pace. That said, we're keeping portfolio duration slightly short relative to the benchmark. We're also overweighting corporate bonds, both high yield and investment grade. We believe corporate earnings are strong, balance sheets are in good shape and steady income is available. As a result, we continue to take advantage of clipping the extra coupon that corporate bonds offer. We view the four- to eight-year maturity bucket as the sweet spot. Our portfolio duration is about four and a half to five years.

5

Where do you see the most attractive opportunities in taxable bonds heading into 2018 and what are the biggest risks for investors that can be neutralized by an active manager?

On the investment-grade side, we favor exploration and production companies and pipeline companies. With oil prices heading in the right direction, they're highly profitable. Banks and other financial companies, which have beefed up their balance sheets, also look attractive. If incoming Fed Chair Powell loosens bank regulations, then those companies are going to benefit. Even without looser regulations, they're still highly profitable.

In high-yield bonds, we've been more nimble. Specifically, in E&P companies, which offer attractive opportunities due to their positive cash flow and debt-reduction efforts. The appetite for acquisitions by other E&P companies in high yield has led to more deals, which are bolstering balance sheets for the sellers. There are also some opportunities in the beaten-up retail sector. We still like packaging, cable and media as solid long-term investments. Elsewhere, we're taking a closer look at telecom, which has a lot of underperforming assets. We're monitoring telecom for opportunities later this quarter or next year.

Right now, the fixed-income market is tight. Interest rates are low and bonds are challenged from a total return standpoint. We had a strong 2016 and a good 2017 as a result of corporates, investment grade and high yield. However, we have to adjust the level of risk we're taking to meet the compensation we're receiving out of fixed income portfolios. We've had a defensive posture. We're elevating quality in our core portfolio positions because we've had a good run and now we're in income mode. We are in a favorable leg of the business cycle and earnings are strong. The big wild card? Geopolitical risk.

** Informa's quarterly ranking recognizes the top 10 performers—before fees—within various asset class peer groups. The Informa peer group was created using the information collected through the PSN investment manager questionnaire and uses only gross of fee returns. PSN Top Guns investment managers must claim that they are Global Investment Performance Standards (GIPS®) compliant. These top performers are strictly based on quarterly returns. While the OIM Corporate Core Plus strategy is only available to institutional investors, retail clients can access the team's expertise through Oppenheimer Investment Advisers. To learn more about the Corporate Core Plus strategy, view the product profile. For more information on our fixed-income strategies, please visit Opco.com.*

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