The Changing Market Environment and the Role of Federal Reserve Policy Actions

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Introduction

In 2008, during one of our country's worst recessions, the Federal Reserve Board of Governors embarked on an unprecedented expansionary monetary policy that included a near-zero Fed Funds rate and a large-scale bond purchase programs, also known as QEs, or quantitative easing. These steps served to keep interest rates low for a long period of time. Quantitative easing officially ended in October 2014 as expectations of a stronger economy, a better employment picture and a move toward a long-term inflation objective began to crystallize. In light of Federal Reserve's unprecedented and, more importantly, untested policy actions, investors have begun to question the potential risk embedded in fixed income portfolios. In an attempt to address existing and potential client concerns, we analyze the current economic environment that challenges the Federal Reserve, and argue that ***any potential interest rate increases will be modest and will not bring us back to the historically normalized levels seen in the 1990 or 2000s.***

As the economy shows signs of a modest recovery, risks to financial stability have moderated, and we have potentially entered an environment in which interest rate movement may be poised to change. We will discuss how the various fixed income markets have performed in past tightening cycles. We will also discuss the active portfolio management strategies we are currently incorporating in our different products in an effort to help clients benefit from a period of possible market volatility.

The Federal Reserve and the Economy

The Federal Reserve's monetary policy objectives are twofold: to keep the economy at maximum employment and to keep prices stable by targeting 2% inflation. To achieve these two objectives, the Fed normally manages monetary policy by raising or lowering the Fed Funds rate. The problem with the current recovery is that it has been grossly uneven, coming in fits and starts. Every positive indicator seems to be accompanied by an offsetting negative. This mixed economic picture calls into question the goals outlined by the Fed's dual mandate and thus hinders any policy actions that would allow the Fed to raise interest rates precipitously.

INSIDE FED TIGHTENING

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Some of the mixed indicators are:

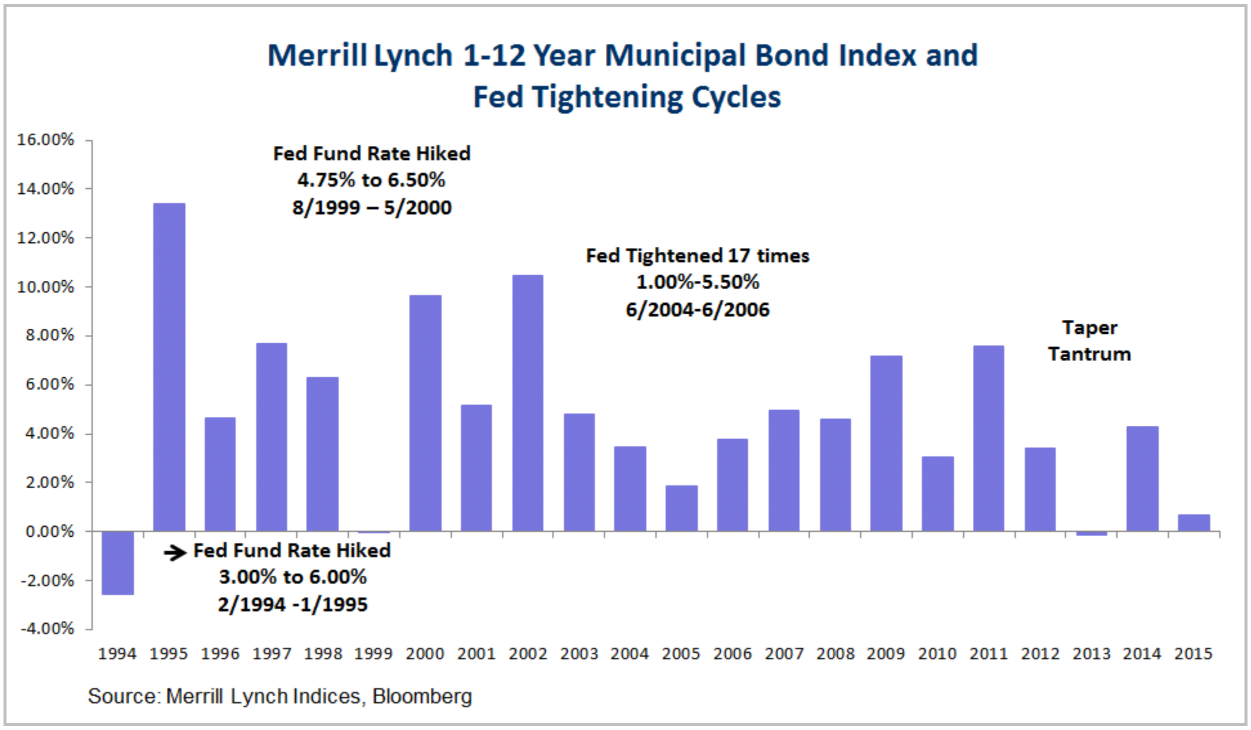
- ***The Employment Rate***: In May 2015, the unemployment rate was reported at 5.4%, down significantly from its high of approximately 10% in late 2009. The employment picture has clearly improved after many years of uncomfortably high levels. Despite the gains in the general employment number, there are several other factors on both the labor and inflation fronts where goals have not been fully attained. First, the number of underemployed workers (Bureau of Labor Statistics - U6), remains high. There continues to be a surplus of workers who desire full time jobs, but who have become discouraged and settled for part-time work because they need a source of income. Similarly, the labor participation rate, defined as the number of people employed or actively looking for work, remains far below the 20 year average of 65.6% despite years of accommodative Fed policy. Taken together, this information implies that, despite a positive headline unemployment rate, internal data show the employment picture to be much more fragile. In our opinion, the current state of employment does not support the type of Federal Reserve interest rate increases that would typically accompany a strong and robust economic picture.

- ***Inflation***: The Federal Reserve has repeatedly stated that future rate changes will be "data dependent." Inflation, however, one of the main factors for deciding any future rate increases, is nowhere to be seen. The inflation landscape has been stuck in neutral with no evidence of any upward movement because prices have remained stubbornly low for several years. Of paramount concern for the Federal Reserve Board is the fact that wage inflation has been virtually non-existent as the index of average hourly earnings has been relatively flat since 2010. In addition, the Federal Reserve's favorite inflation gauge, the Personal Consumption Expenditures (PCE), which is the primary measure of consumer spending on goods and services, has remained stubbornly below its stated target rate of 2.0%. Inflationary concerns have historically been the driving force behind higher interest rates. As we assess the overall inflation landscape now, we consider it apparent that the inflationary component of the Fed's dual mandate has not even begun to rise and is not anywhere near reaching the goal intended for it at this time. We believe this neutral inflation status is yet another signal that any potential interest rate increases will be muted.

- ***GDP Growth****:* Weaker exports, tied to the strong dollar, and weaker international growth levels in China, Europe and Japan have led to a domestic economy that seems anemic and is at best muddling along. Any dramatic rise in interest rates could push an already fragile economy back into recession – an outcome that no one from the Fed wants.

When the time to increase the Fed Funds rate arrives, we believe the Federal Reserve will err on the side of caution and gradually raise short-term interest rates over a long period. We envision a scenario where the initial rate hike could be small – perhaps .25% to .50 %. Thereafter, it might potentially be followed by only one or two more modest rate hikes.

Investment Grade Municipal Bond Market and Fed Tightening Cycles



During the past 20 years, the Merrill 1-12 year municipal bond index posted only two periods of negative returns. The worst period for intermediate bond returns was during the 1994-1995 tightening cycle when the Fed aggressively ratcheted up the funds rate by 3.00% in less than twelve months, beginning at 3.00% in February 1994 and ending at 6.00% by the end of January 1995. The Merrill Lynch 1-12 year municipal index declined 2.50% in 1994 due to this aggressive contraction of monetary policy. The interest rate increases during this period were a function of a sharp economic rebound with fears of accelerating inflation rates. In other words, they represented an economic environment that is vastly different from today's mixed and muted economic growth.

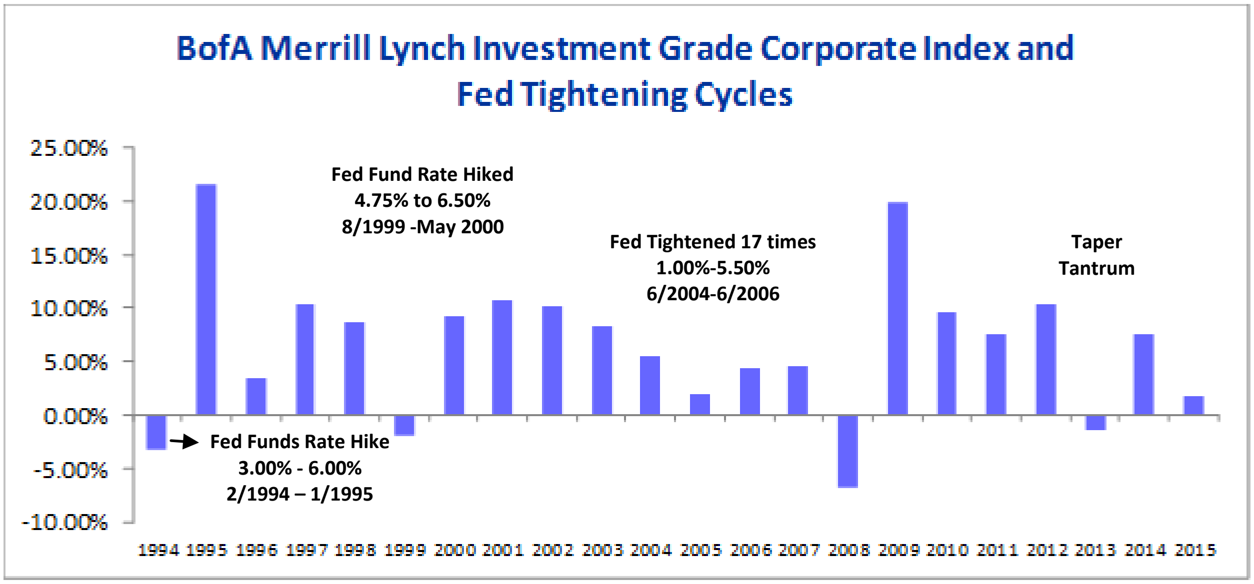
The second period of negative returns for municipal bonds surprised the markets and was not related to an actual change in the Fed Funds rate policy. The so-called "taper tantrum" occurred in May 2013 when then-Fed president Ben Bernanke alluded to a cessation of asset purchases. This announcement caught the market by surprise and resulted in 10 year U.S. Treasury (UST) rates moving from 1.70% in May of 2013 to just shy of 3.00% only a short four months later. Even during this turbulent period, the Merrill 1-12 year index was essentially flat and ended the year at a modestly negative .11%
In an effort to achieve portfolio stability in a new era of Fed policy, the key themes in the investment grade tax exempt portfolio are as follows:

- We are targeting a **neutral duration** – an average maturity of approximately 5 years and average duration of 4 years – while allowing seasoned portfolios to age down into a somewhat shorter duration in an effort to protect on the downside should the market experience a shock from rising rates.

- We are buying essential revenue and general obligation bonds with an **average underlying rating of “AA.”**. We are increasing our weighting on “A” rated credits to enhance the income in the portfolio. We anticipate that municipal credit quality will improve along with the general economy.

- We continue to favor the **barbell structure**. We anticipate that the curve will flatten as short term yields rise while longer term yields stay relatively stable.

Investment Grade Taxable Bond Market and Fed Tightening Cycles



Source: Merrill Lynch Indices, Bloomberg

Since 1994, the Investment Grade Corporate Index has posted a negative return four times; it showed a decline of over 2.00% only twice. During the Fed's 1994 tightening cycle, investment grade corporate bonds posted a negative return of -3.34%. The Fed's 1999-2000 rate increasing cycle also led to a more modest negative return of -1.89%.

The dramatic 2008 decline, however, was a result of the broad-based selloff in corporate credit due to the unique situation of the dramatic financial meltdown that led to the Great Recession.

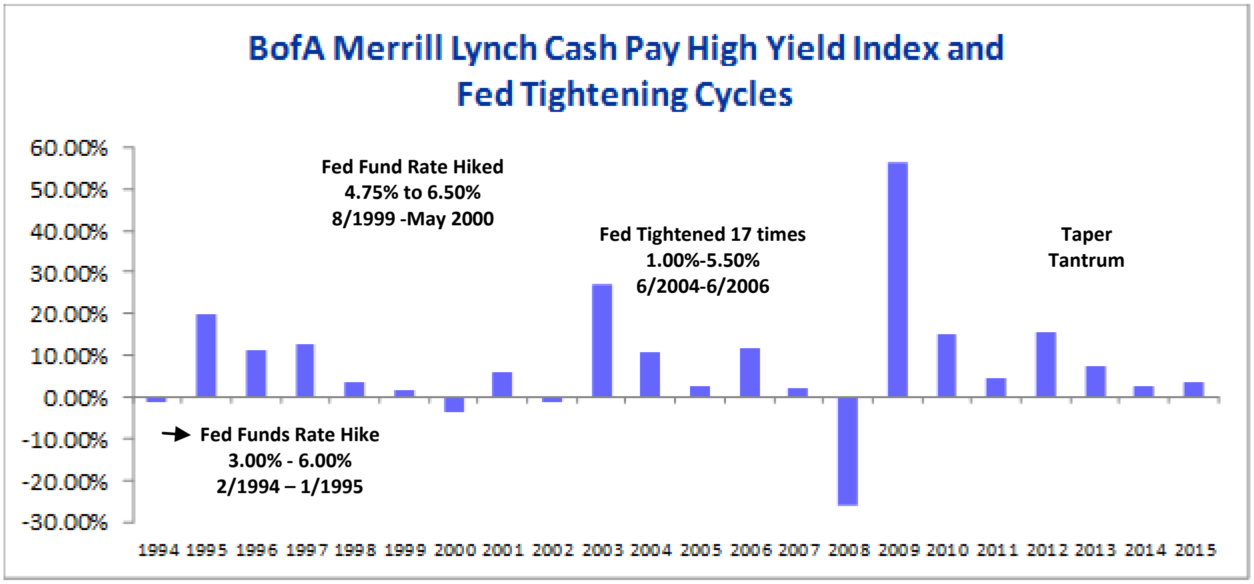
Duration management and credit selection will be keys to achieving respectable returns in 2015.

- We will remain **short in duration** versus our benchmarks (4-5 years and less). Portfolios will contain no long maturity bonds, and we will be investing in short to intermediate maturities.

- We continue to **overweight corporate credit**. Historically, corporate exposure has reduced interest rate risk in a portfolio. Corporate credit fundamentals remain at the strongest levels in 25 years and therefore remain "carry friendly."

- In addition, we continue to **underweight** the US Treasury, Federal Agency and Mortgage-Backed sectors as we believe relative value is lacking.

High Yield Taxable Bond Market and Fed Tightening Cycles



Source: Merrill Lynch Indices, Bloomberg

In the past twenty years, the Merrill Lynch Taxable High Yield (Cash Pay) Index has posted a negative return four times. During the Fed's aggressive 1994 rate increasing cycle, the index posted a negative return of only -1.17%. During the Fed's 1999-2000 rate increasing cycle, HY's posted a negative return of -3.79% however that return was more the result of the tech stock crash followed by the telecom crash. Then, in 2002, it was also down, with a negative return of -1.14%. The most dramatic decline in the high yield market occurred in 2008 when the High Yield Index posted an unprecedented double digit loss of 26.38%. As we previously mentioned, the loss in 2008 was not a function of Fed policy, but instead of a broad based sell off in corporate credits due to the financial banking crisis.

- Typically, High Yield credits will perform well moving into, and during, the Fed's fund rate increasing cycle, because the Fed will only move rates higher as a result of an improving economy. In general, an improving economy has a greater positive effect on overall HY credit quality rather than rising interest rates, unless the Fed moves rates higher at a faster pace than the economy can tolerate.

- We anticipate that the rate increase that the Fed is currently signaling will commence later this year or in early 2016 and will be conducted in a very slow and manageable fashion. As a result, we do not expect a near-term negative return for the HY asset class that can be attributed to the Fed's rate movements.

Conclusion

We believe that the environment for longer-term fixed income investors remains positive, even if the Fed raises interest rates modestly, for several reasons. First, the frequency of years in which negative total returns have been generated has been very low over the past 20 years. Second, the extent of the losses in those years was surprisingly mild given the level of rate increases imposed by the Fed. Although 2008 is a significant exception, we believe that the sequence of events in that year were unique and are unlikely to reoccur.

- **We believe that the current economic environment of subdued growth does not support significant interest rate increases.**
- **While the Federal Reserve may raise interest rates symbolically later this year or in early 2016, we do not see them rising to the normalized levels of the 1990s and 2000s.**
- **The economy has not fully recovered in all areas. Therefore, any interest rate increases now will likely be different than in past tightening cycles. They may, in fact, signal a buying opportunity for high-quality fixed income investors.**

As active managers, Oppenheimer Investment Advisers (OIA) attempts to help reduce a portfolio's sensitivity to rising rates through portfolio yield curve positioning and duration management as well as credit selection. When investors face a rising rate scenario, the importance of both duration and maturity management comes into sharper focus. Even though we may enter into a period of volatility in the fixed income markets should rates rise unexpectedly, we attempt to mitigate the downside risk through a professionally managed total-return fixed income portfolio.