DISSECTING HEADLINES FROM THE FIRST YELLEN FED MEETING

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03/25/2014

During the first meeting of the Janet Yellen era, the Federal Reserve (Fed) surprised investors with a more hawkish tone than expected, pushing 10-Year Treasury yields to the middle of their recent 2.6%–3.0% trading range.[1] Additionally, with the perception that rates may rise in the U.S. sooner rather than later, the U.S. dollar rallied against most other foreign currencies. Our first look at Yellen's Fed provided these insights: 1) **Tapering Continues** – The Fed will maintain the path of tapering by an additional $10 billion to $55 billion in total purchases for April. 2) **Blame It on the Weather** – The committee noted that U.S. economic data had weakened slightly, but it largely attributed this slowdown to the weather. 3) **Greater Flexibility in Forward Rate Guidance** – The Fed altered its forward rate guidance to be more qualitative, in effect removing the previous 6.5% employment threshold for rate hikes. 4) **A Lift in Policy Rate Forecasts** – Median estimates for the Fed policy rate went from 0.75% to 1.0% for the end of 2015, and from 1.75% to 2.25% for the end of 2016. The committee also updated the speed at which interest rates will rise: 10 out of 16 members see rates rising to 1.0% by the end of 2015; at the December meeting, 10 out of 16 saw rates below 1% by the end of 2015. This first meeting also featured the first misstep of the Yellen era. There is a popular saying among economists: *Give either a specific forecast about what will happen in the future or a specific time by which it will occur, but never both.* When asked to clarify the meaning of "considerable time" after asset purchases end during her press conference, Yellen offered a window of "six months or that type of thing" for the first rate hike after the end of quantitative easing. After quickly doing the math, investors realized that tapering could be over in October and that the Fed's first rate hike could occur as early as April 2015. Many pundits denied that she meant to imply a Fed rate hike at this time and at that date. Regardless, if she and the Fed sought to provide clarity and communicate no change in their policy intentions, success eluded them. In aggregate, the Fed statement and comments likely provided a subtle lift to investor views on the economy and expectations that the first Fed rate hike would come a little sooner than late 2015. In our view, should current concerns about Russia and China fade into the background, investors are likely to assess incoming domestic data with this as their primary reference point. Stronger-than-expected economic momentum could rekindle investor fears of rising rates and lift the dollar against other currencies. We advocate that clients maintain their focus on geopolitical events in the near term but look to reduce their interest rate risk as economic strength materializes in the coming months. **How Should Investors Be Thinking about Their Positioning as a Result?** The rosier assessment of the economy and the hawkish tilt from the Fed suggest that investors should reconsider positioning for both rising U.S. rates and a stronger U.S. dollar. On the interest rate side, if economic momentum pushes the Fed to hike rates earlier, investors who sought protection from rising rates by merely shifting into shorter-duration fixed income securities could be vulnerable. For many investors, targeting a duration of three to five years in their fixed income portfolios became popular after former Fed Chairman Ben Bernanke hinted about the possibility tapering last May.[2] Unfortunately, as money has flooded into that segment of the yield curve, valuations have become stretched. Should the Fed initiate a tightening cycle earlier than the fall of 2015, this crowded portion of the yield curve could come under significant pressure. As an alternative, a comparatively attractive strategy may be for investors to establish a position in a zero duration bond portfolio. This can be accomplished by investing in a portfolio of bonds but then employing an overlay strategy of Treasury futures contracts in order to hedge the interest rate risk component of the bond portfolio. In this portfolio, investors have taken a long position in a credit spread that essentially seeks to isolate the additional income in excess of presumed "risk-free" Treasury bonds.[3] The level of income is determined by the degree of credit risk that investors are comfortable taking. In the case of a zero duration aggregate portfolio[4], this yield in excess of Treasuries is approximately 0.73%. In the case of a similarly constructed high-yield allocation[5], investors could see yields in excess of 4.3%. When compared to a Two-Year Treasury yield of 0.42%,[6] these trades may offer value for assuming credit risk as opposed to interest rate risk (duration). **Thoughts on U.S. Dollar Positioning** Investors entered the year anticipating a stronger U.S. dollar only to be disappointed as economic data diminished the perception of a U.S.-led global recovery. The yen showed some resiliency, and the euro strengthened on continued signs of recovery. In our view, the Fed's statements reinforce the perception that policy makers are much closer to raising rates than the European Central Bank and the Bank of Japan. Investors could look to re-establish their long dollar positions in anticipation of stronger data validating the Fed's view of the economy. Investors can achieve a broad-based exposure to a stronger dollar in a variety of ways, including hedging the currency risk of their international equity positions. Dollar-bull strategies—currency positions structured to directly benefit from an appreciating dollar against foreign currencies—can provide a unique diversifier as part of traditional portfolios. Historically, these positions tend to exhibit negative correlations with traditional bond and equity investments. This is particularly valuable during rising rate environments, when valuations of these traditional assets can come under pressure. When considering such positions, an investor needs to look to broad-based exposures, which better offset the potential risks of unhedged exposures in international equity portfolios. Ultimately, we believe that until positions can be further clarified or the future becomes clearer, investors may be wise to take Fed Chair Yellen's comments at face value. Although we agree that the path of future U.S. interest rate policy is not on a preset course, reducing exposure to positions that will be most sensitive to increases in short-term interest rates or increasing positions that benefit from dollar strength could be a prudent course of action. [1]Source: Bloomberg, as of 3/20/14. [2]Source: WisdomTree, as of 12/31/13. [3]Investors compensation also includes returns from short-term money market rates. [4]As represented by the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration. [5]As represented by the BofA Merrill Lynch 0-5 Year US High Yield Constrained Index, Zero Duration. [6]Source: Bloomberg, as of 3/21/14.

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DEFINITIONS

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.

Treasury yield : The return on investment, expressed as a percentage, on the debt obligations of the U.S. government.

Tapering : A shift in monetary policy by which the Federal Reserve would begin decreasing the amount of bonds it purchases.

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Asset purchases : The Fed purchases longer-term securities issued by the U.S. government and longer-term securities issued or guaranteed by government-sponsored agencies such as Fannie Mae or Freddie Mac.

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Interest rate risk : The risk that an investment’s value will decline due to an increase in interest rates.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Overlay strategy : overlaying debt instruments on top of an existing portfolio.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).

Credit spread : The portion of a bond’s yield that compensates investors for taking credit risk.

Credit risk : The risk that a borrower will not meet their contractual obligations in conjunction with an investment.

Correlation : Statistical measure of how two sets of returns move in relation to each other. Correlation coefficients range from -1 to 1. A correlation of 1 means the two subjects of analysis move in lockstep with each other. A correlation of -1 means the two subjects of analysis have moved in exactly the opposite direction.

Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration : Combines long positions in the Barclays U.S. Aggregate Bond Index with short positions in U.S. Treasury Bonds to provide a duration exposure of 0 years. Market values of long and short positions are rebalanced at month-end.

BofA Merrill Lynch 0-5 Year US High Yield Constrained, Zero Duration Index : Tracks the performance of the combination of a long position in short maturity US high yield bonds and a short position in on the run US Treasuries where the net interest rate exposure of the index is adjusted to a zero year duration. Market values of long and short positions are rebalanced at month-end.