Rates

Pre- and Post-Election Rate Moves

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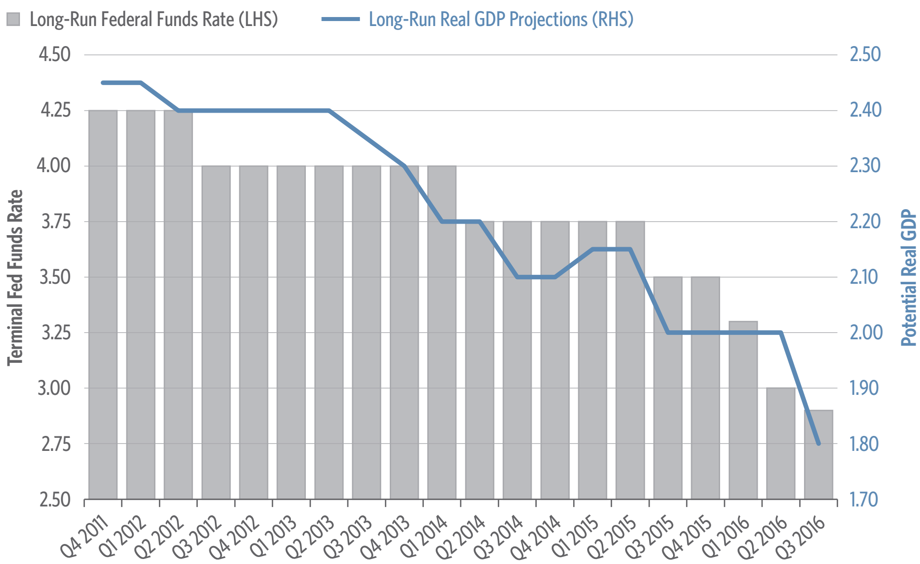
A rising fed funds rate suggests investors should prepare for the curve to flatten.

A combination of U.S. and global central bank developments were driving factors for global interest rates during the third quarter of 2016. As expected, the Fed held rates unchanged until the December FOMC meeting, when it raised short-term rates from 0.25–0.50 percent to a range of 0.50–0.75 percent. Our macroeconomic team believes the Fed will remain data dependent through 2017, which calls for a shallow rate hiking cycle. This is in line with the consistent drop in the FOMC's median projections for the long run fed funds rate, which is only 2.9 percent as of September 2016. The FOMC's median projection for future economic growth has also been reduced to only 1.8 percent (see chart, top right). Globally, the BoJ maintained its policy rate at -0.10 percent, while also introducing a new policy of yield curve control, targeting 0 percent for the 10-year Japanese government bond and committing to expand the monetary policy base until inflation moves above 2 percent. As a result of these policy actions, Treasury yields increased marginally and the yield curve flattened prior to the U.S. presidential election. After the election, the market, discounting Trump's anticipated fiscal stimulus, caused the yield curve to steepen.

During the course of the third quarter, the two-year Treasury yield increased from 0.58 percent to 0.76 percent, and the 10-year Treasury yield increased from 1.47 percent to 1.60 percent. With the move to higher yields, the Barclays U.S. Treasury index generated a total return of -0.3 percent for the quarter and a year-to-date total return of 5.1 percent. Agency spreads tightened and the Barclays U.S. Agency index generated a total return of 0.3 percent for the quarter and a year-to-date total return of 4.5 percent. The Barclays Global Treasury index generated a total return of 0.8 percent for the quarter and a year-to-date total return of 12.0 percent.

In the third quarter, the BoJ's policy move reduced implied interest rate volatility significantly (see chart, bottom right), thus diminishing the attractiveness of selling volatility through callable Agency securities. The collapse in implied volatility caused us to avoid callable Agencies given tight spreads. However, the U.S. presidential election outcome caused both implied volatility and spreads to rise, so we have been buying callable Agencies again in the fourth quarter. We are also finding attractive investment opportunities in longer maturity Agency bullets and strips given our view that the yield curve will ultimately flatten as we move further into the later stages of the economic cycle.

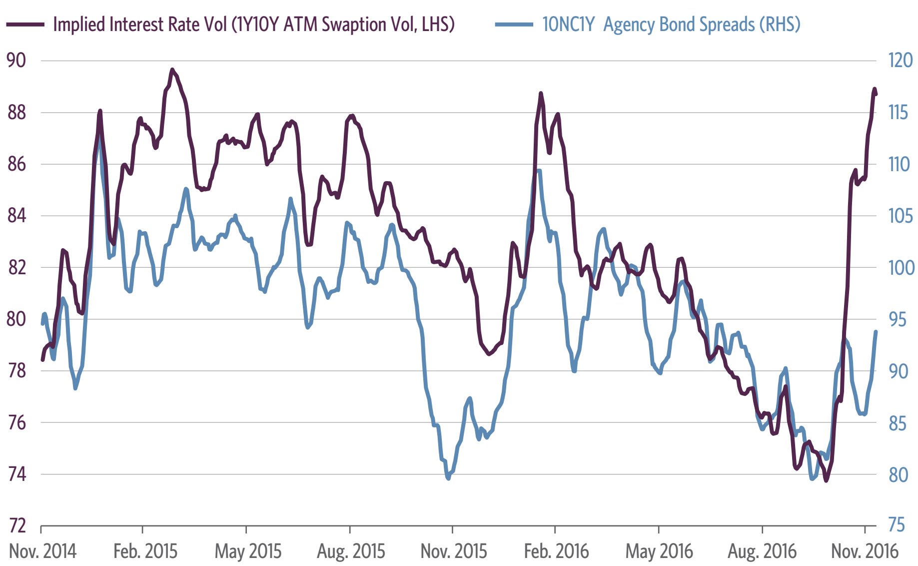
More Evidence of Lower for Longer



Source: Federal Reserve, Guggenheim Investments. Data as of 9.30.2016.

The median FOMC member projection of long-run fed funds rate fell three times in 2016, supporting our view that the Fed will maintain a slow and gradual pace of tightening. Declining median projections of long-run real GDP growth has also fallen in lockstep with declining rate projections. We will be closely watching these projections in 2017 as the new administration makes progress in Washington.

Implied Interest Rate Volatility Spiked After a Long Decline



Source: Bloomberg, J.P. Morgan, Guggenheim Investments. Data as of 10.15.2016.

The "1Y10Y at-the-money swaption" volatility is a measure of expected interest rate volatility, akin to the Chicago Board Options Exchange Volatility Index (VIX) measure for equity markets. Foreign central bank commitments to keep rates low caused implied volatility to decline in 2016. As a result, callable Agency bonds spreads, which are sensitive to changes in market rates and implied volatility, looked expensive relative to historical spreads. Implied volatility spiked significantly after the election, making callable agencies attractive again.