Rates

Sea Change

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The Fed's policy pivot sets the stage for attractive opportunities in higher-quality rates products.

The first quarter of 2019 brought about a sea change in monetary policy direction from the Fed and overall capital market sentiment. Citing a weaker outlook for growth and contained inflation, the FOMC's Summary of Economic Projections, or dot plot, showed no further plans to tighten policy in 2019 from the current fed funds target rate of 2.25–2.50 percent (see chart, top right). This marked a significant shift from its December meeting, at which most members had projected at least two hikes. Additionally, the Fed's plans for balance sheet normalization indicated a sooner-than-expected end to the program. In reaction to these new developments, the three-month/10-year Treasury yield curve inverted (see chart, bottom right), historically a precursor to a recession.

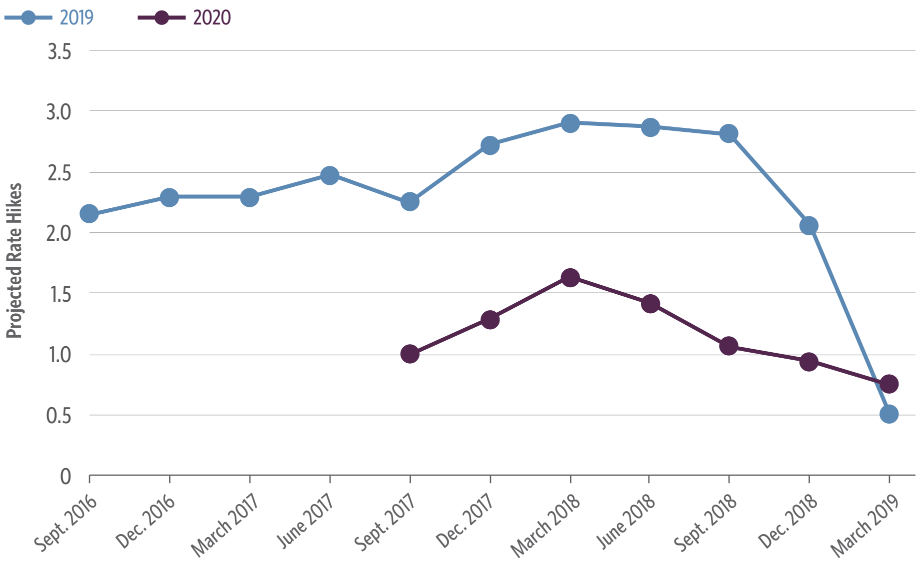
The Fed's shift in tone drove a decline in U.S. Treasury yields of 20–30 basis points across the curve, generating another strong quarter of returns for the asset class. The U.S. Treasury market delivered a total return of 2.1 percent in the first quarter and the Agency market produced a total return of 1.8 percent. The move to lower yields was seen across global developed markets, and the Bloomberg Barclays Global Treasury index returned 1.6 percent in the first quarter.

With the Fed likely to remain on hold until it receives a clearer sign that the rate change is necessary, we believe that Treasury yields are likely to remain below last year's peak and that high-quality, longer duration assets such as Agency bonds could perform well as investors reach for yield. Additionally, the inversion of the three-month/10-year Treasury yield curve, coupled with our view that the yield curve lacks catalysts to flatten materially from current levels, prompted us to move to a more neutral curve position by decreasing our long-end Treasury holdings and adding to our Treasury holdings at the short end and belly of the curve. With the relative steepness of the Treasury curve in the belly, we will be on the lookout for relative-value trading opportunities.

Note: "Rates" products refer to Treasury securities and Agency debt securities. Treasury and Agency returns are represented by the Bloomberg Barclays Treasurys index and the Bloomberg Barclays U.S. Agency index, respectively.

FOMC's "Dot Plot" Shows No Expectation of Another Rate Hike

Average Number of Rate Increases Forecasted by FOMC Participants

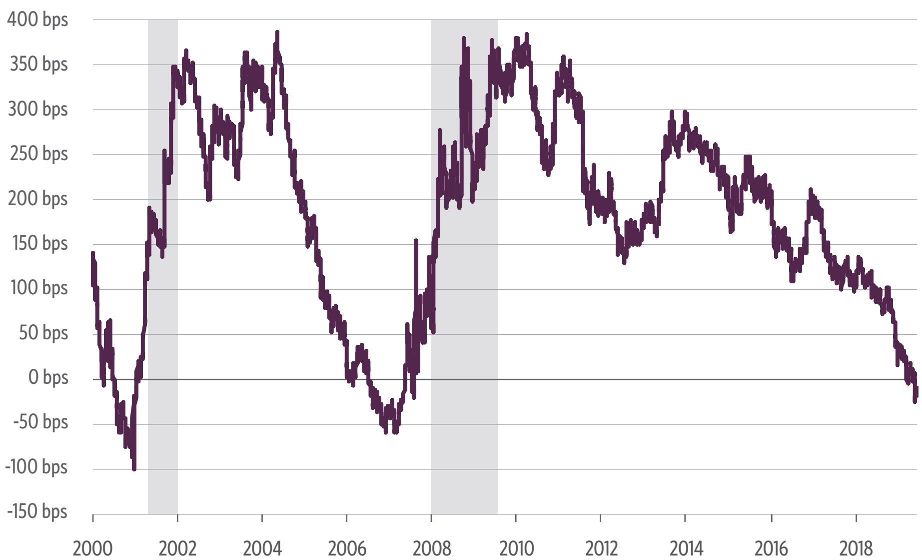


Source: Guggenheim Investments, Federal Reserve. Latest data from the FOMC's March 2019 Summary of Economic Projections.

The Fed has left rates unchanged at every FOMC meeting thus far in 2019. The average number of hikes projected by FOMC participants is now below one for both 2019 and 2020 based on the March 2019 Summary of Economic Projections, which underscores the Fed's intention to remain on hold.

An Inverted Yield Curve Has Historically Been a Precursor to Recession

Three-Month/10-Year Treasury Yield Curve



Source: Guggenheim Investments, Bloomberg. Data as of 6.12.2019.

In reaction to the removal of the Fed's hiking bias and plans to end its balance sheet runoff earlier than expected, the three-month/10-year Treasury yield curve inverted, historically a precursor to a recession.