In the Know: Fed Lifts Rates, but "Lower for Longer" Likely

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In the Know: Professionals from Franklin Templeton Investments offer a brief but insightful update on a pressing investment topic.

The markets can finally put the US interest-rate debate to bed (at least for the time being) as the Federal Reserve lifted its benchmark short-term lending rate for the first time in a year. While it appears that further US rate hikes are likely ahead, Franklin Templeton Fixed Income Group's Chris Molumphy believes the "lower-for-longer" interest-rate environment is likely to persist. He also cautions against some of the market exuberance that has been following the US presidential election.

Q: What's your perspective on the Federal Reserve's (Fed's) decision to raise short-term interest rates?

A: Overall, we think the Fed's move was a healthy course, given the unusually low level the federal funds rate has been at for a long period of time. The increase was long anticipated and fully priced into the market, so we think it's more important to look at the Fed's guidance in terms of where rates might be going in 2017 and beyond.

The federal funds rate remains extremely low (even after this increase), and we would anticipate that short- and even long-term interest rates are likely to remain quite low going forward. As we look into 2017, we are likely to see the federal funds rate averaging somewhere around 1%, which is still extremely low. While we would anticipate there to be more interest-rate increases ahead, we'd expect them to be gradual. Remember, it was December 2015 when the Fed raised rates for the first time in this cycle, so we've seen a full 12 months between increases. We expect the time frame for the next rate hike to likely contract going forward, but we see the pace of increases being extremely gradual, something on the order of 0.75% per year for the next couple of years. While interest rates are rising, we think the nominal rates and pace of future increases need to be kept in mind.

Q: What are the implications of rising rates for fixed income investors?

A: First, we have to be careful to differentiate between short- and long-term rates. We'd anticipate the Fed to continue to raise short-term rates in 2017 and beyond, but long-term rates move in anticipation of Fed actions, and we have already seen a pretty significant move higher. Thus we wouldn't necessarily see a significant additional rise in longer-term rates.

In terms of different types of asset classes within the fixed income space, it's difficult to generalize because different asset classes are driven by different factors and have different interest-rate sensitivities. For example, leveraged bank loans, which are floating rate in nature and very low-duration assets, could do well in a rising short-term interest-rate environment as they continue to adjust with rising rates.

Another interesting asset class is high-yield corporates, which are typically thought of as an intermediate-term and intermediate-duration asset class. Since the US election, intermediate rates have gone up pretty significantly but high-yield corporates tend to be driven just as much by the economy and expectations for growth as they are by interest rates. Looking at recent performance, the equity-type component of high yield has more than offset the duration component—duration being the sensitivity of the instrument's price to changes in interest rates.

Meanwhile, municipal bonds have suffered recently, because they tend to be longer-duration assets. There's no question they've been hurt by rising long-term rates, but the important thing to keep in mind is that ultimately, over the long term, the asset class could benefit, because if intermediate- and longer-term rates rise, the ability to reinvest money in higher-yielding securities should ultimately benefit longer-term holders. So again, it's important not to generalize with respect to rising rates but to understand the impact on different asset classes, and to diversify.

Q: With talk of increased fiscal spending ahead in many countries, what do you see as the economic and monetary implications?

A: The market has clearly run with a theme of increased fiscal spending, with the potential result being higher rates of economic growth and likely higher interest rates. We've seen a "risk-on" rally with many investors favoring risk assets such as equities and high-yield corporates. We would ask whether the market is a bit ahead of itself, and our answer to that is probably yes, at least in the short term.

In the United States, we heard predictions that Donald Trump's administration will likely bring potentially higher spending in infrastructure and lower taxes. When we look at the details in terms of the amount of these two potential initiatives and the timing, we think the market is likely overstating the effects to some degree.

Looking at taxes alone, we must remember US debt has roughly doubled in the past six-to-seven years, so we have a starting point of roughly 75% debt-to-gross domestic product, which is fairly high. And, the US annual deficit has already bottomed. Putting those together, as we move forward with a Republican-controlled Congress, it's hard for us to envision significantly higher deficit-related spending in the form of fiscal spending broadly or reduced taxes.

On the federal level, the United States currently spends a relatively modest amount on infrastructure, but even if it were to increase significantly on a percentage basis, the timing of implementation is likely to be delayed. As we learned in 2009 and later, shovel-ready projects tend to be few and far between.

On the tax side, the size of a potential tax reform bill has been reduced; we had initially heard numbers like $10 trillion over a decade during Trump's campaign, but more recently, the total cost of the plan has been lowered to about $3 trillion spread over a decade. While the market already seems to be reacting, we will still have to wait for details of any plan, but we think the timing and amount of tax packages in the future are likely to be spread out and smaller than initially anticipated.

Q: In your view, does the changing US political landscape impact your investment strategy or outlook going forward in any way?

A: While politics make great headlines, it is economic fundamentals that drive markets long term. We tend not to change our strategy significantly based on the political landscape, but this political season has been unusual in many ways, and we are spending a lot of time analyzing the potential impacts.

We are cautiously optimistic that the backdrop of potentially lower regulation and lower taxes could be a net positive for US economic growth and the corporate environment broadly, but many of the potential changes are likely easier said than done. To not anticipate any bumps would be overly optimistic. The markets may be overly exuberant about some of the potential positive changes coming down the path, and we think the exuberance should probably be tempered a bit. As investors, we are evaluating the reality of potential policy changes occurring versus what's being priced in the current market.

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