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Fed's Exit Plan Rattles Bond Market

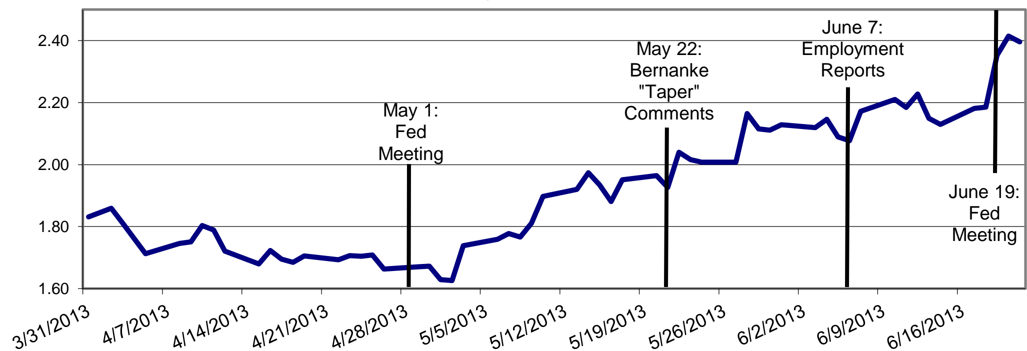
HIGHLIGHTS

- Chairman Bernanke has laid out more detail for potential removal of QE3
- "Tapering" of accommodation may begin as early as this year
- Interest rates sharply higher; markets looking ahead to less accommodative Fed

The week-long blackout period leading up to the Federal Open Market Committee's two-day session felt a bit longer than usual. A great deal of anticipation mounted over what the FOMC would detail in their June 19th release in regard to their asset purchasing programs, and the wait built up a formidable amount of energy in domestic markets.

Over the past several months, US economic activity has shown modest signs of life, getting us closer to the point when the US recovery could potentially sustain itself with a decreased amount of Fed support. In late May, Fed Chairman Bernanke's now-infamous acknowledgment of potentially "tapering" monthly asset purchases added fuel to the sell-off in US debt markets.

10 Year US Treasury Yield With Economic Milestones



Source: Bloomberg

Using Wednesday's press conference, the FOMC refined its communications to imply that a reasonable foundation has been laid for the reduction/elimination of the latest round of Quantitative Easing. In other words, they have opened the door for an exit. The initial result has been a spike in yields as the artificial Fed bid in Treasuries is 'anticipated' to be withdrawn in the next 6 to 9 months. Clearly, the decision process is conditioned on targets that still face headwinds.

Our view, though, is that markets have turned an important psychological corner and expectations are now aligned with economic results that drive the subsequent repeal of QE. For some time now, we have viewed high unemployment and weak housing as key metrics putting a lid on the upward volatility of interest rates. 2013 has seen housing beginning to show sustainable signs of life and a continued slow and steady improvement in the employment picture. These developments, in conjunction with the Fed's changed language, are beginning to remove that lid and open up incremental room to the upside for rates. With that said, each economic release or policy statement from this point forward will either confirm or reset expectations.

As of now, the inflation and employment targets for raising the Fed Funds Rate are out of reach. Also, a host of economic challenges are still dampening the recovery, including the effects of sequestration, which may not be fully felt until later this year. Add to that the disruption to the wealth effect caused by falling stock prices or a stall in the housing recovery (given higher mortgage rates) and there continues to be more than enough to impede the speed of the exit.

In summary, we do not believe we are experiencing a 1994 trajectory to higher yields, and we believe the Fed Funds Rate is likely stable until at least 2015. However, longer dated bonds which have been the target of the QE initiatives are at risk because the big buyer in town is planning an exit. Markets clearly have a bias toward higher yields as long as that exit seems likely, and this will hold unless altered by a causal factor. Our portfolio strategies are being managed with a view to those biases and the unexpected. Elevated price volatility is likely across all asset classes as the flow of releases and statements seeks to refine how QE ends.

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