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FOMC doesn't raise rates. Scales back forecasts for the entire year.

By Robert B. Segal, CFA, Atlantic Capital Strategies, Inc.

The Federal Open Market Committee (FOMC) kept the target range for the fed funds rate at 0.25 percent to 0.50 percent, and scaled back forecasts for how high interest rates will rise this year. The median of policy makers' updated quarterly projections saw the rate at 0.875 percent at the end of 2016, implying two quarter-point increases this year, down from four in December.

"The committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will expand at a moderate pace and labor market indicators will continue to strengthen," the FOMC said. "However, global economic and financial developments continue to pose risks."

"Economic activity has been expanding at a moderate pace," with household spending gaining amid "soft" company investment and net exports, the Fed said. While inflation has "picked up in recent months," market-based measures of inflation compensation are still low, the central bank said.

The median of Fed officials' projections, known as the "dot plot," saw the fed funds rate at 1.875 percent at the end of 2017, compared with 2.375 percent forecast in December. The end-2018 level fell to 3 percent, from 3.25 percent, with the longer-run projection at 3.25 percent, down from 3.50 percent.

"Caution is appropriate," Fed Chairwoman Janet Yellen said in a news conference following the meeting, characterizing the approach in dealing with a vulnerable economy and a central bank with few tools to respond if new threats disrupt the expansion. She also said it remained to be seen whether a recent firming in core inflation, which excludes volatile energy and food components, would be sustained. "In particular, the earlier declines in energy prices and appreciation of the dollar could well continue to weigh on overall consumer prices."

The market is pricing in no chance of a rate increase for the FOMC meeting in April. According to the CME Group, the probability rises to 50 percent by July and 80 percent for December. A Bloomberg survey of economists suggests the Fed will move once in the second quarter of 2016, and bring overnight borrowing costs to 0.88 percent by the end of 2016.

In financial markets, government bonds continue to rally. The yield on the benchmark 10-year Treasury note traded recently at 1.90 percent, compared with 2.30 percent at year-end 2015. Based on futures markets, the yield will rise to only 2.10 percent by the end of 2016.

In this environment where long-term rates are expected to remain low, financial institutions have been scooping up municipal bonds in an attempt to improve current income. In fact, banks have surpassed both money market funds and insurance companies to become the third-largest holders of municipal securities, according to the Federal Reserve.

The size of the municipal bond market has been relatively stable the past few years as municipalities have issued less "new-money" debt. The Fed, in its most recent Flow of Funds report, said the municipal market at the end of the third quarter of 2015 totaled $3.71 trillion, similar to the level in 2011. Banking institutions held $511 billion, up from $398 billion as recently as 2012. Banks have been boosting their holdings in municipal bonds steadily over the past decade, say the Federal Reserve numbers.

Industry reports generally show that institutions

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holding larger percentages of municipal bonds tend to be the high-performers. For example, banks holding at least 30 percent of their investment portfolios in munis are typically found in the first quartile for investment yield, which is often 3 percent or higher.

A primary benefit of municipal bonds is the long period of call protection. Bank investment officers may be relatively certain they'll hold on to the initial yield for seven to 10 years, regardless of interest rate movements. This is as opposed to Callable Agency bonds or certain mortgage securities, which will inundate investors with cash to reinvest when interest rates are low. With considerable optionality on most bank balance sheets, municipals provide much-needed predictable cash flow. In addition, the municipal curve is steep, and this will provide some price protection for a rising rate environment.

Municipal bonds outperformed other asset classes in 2015, beating corporates, Treasuries and the major stock indexes. The S&P Municipal Bond Index posted a total return of almost 3.2 percent, compared to a 0.81 percent loss in the Merrill Investment Grade Corporate Bond Index and a 0.84 percent advance in the Barclays Treasury Index. For 2014, munis beat corporates by 2 percent and by more than 5 percent for Treasuries.

Most economists expect another year of slow, but steady growth and muted inflation. Assuming the economy continues on this path, then municipal bonds should provide another year of positive returns. Financial institutions looking to boost income may wish to evaluate this sector more closely as a viable investment option.

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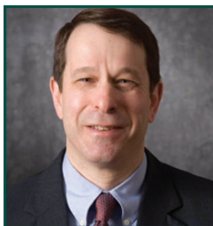

About the Author

Robert B. Segal, CFA, is founder and chief executive officer with Atlantic Capital Strategies, Inc. Bob has been in the banking industry since 1982, having worked in several community banks with roles in mortgage banking, sales and trading, and asset liability management. He is a frequent speaker at industry events and contributes to many regional and national finance publications.

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Financial Managers Society
1 North LaSalle Street, Suite 3100
Chicago, IL 60602
info@fmsinc.org

Contact: markl@fmsinc.org | 312-578-1300
www.fmsperspectives.com

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