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Fed elects to punt: Eyeing the end of the year, FOMC leaves rate unchanged again

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The Federal Reserve left its policy rate unchanged for a sixth straight meeting, saying it would wait for more evidence of progress toward its goals, while projecting that an increase is still likely by year-end.

"Near-term risks to the economic outlook appear roughly balanced," the FOMC said in its statement after a two-day meeting in Washington. "The Committee judges that the case for an increase in the federal funds rate has strengthened but decided, for the time being, to wait for further evidence of continued progress toward its objectives."

Three officials, meanwhile, dissented in favor of a quarter-point hike. Esther George, president of the Kansas City Fed, voted against the decision for a second straight meeting. She was joined by Cleveland Fed President Loretta Mester and Eric Rosengren, head of the Boston Fed.

The central bank's "dot plot" showed that officials expect one quarter-point rate increase this year. Officials scaled back expectations for hikes in 2017 and over the longer run. Policymakers see two rate hikes next year, down from their June median projection of three. They see the Fed funds rate settling in at 2.9%, down from a 3% guess in June.

"Our decision does not reflect a lack of confidence in the economy," Fed Chair Janet Yellen said at the press conference. "Since monetary policy is only modestly accommodative, there appears little risk of falling behind the curve in the near future." She noted that a "cautious" approach is all the more appropriate given that short-term rates are still near zero, and therefore the Committee can more effectively respond to inflation pressures by raising rates than to falling inflation by cutting rates.

At this time, markets place the chance of a rate increase by year-end at 60%, down slightly from 65% after the Fed's April 27th meeting. This compares with only 10%, however, at the end of June. The yield on the benchmark 10-year Treasury note traded recently at 1.65%, compared with 1.85% at the end of May.

In its latest banking profile, the FDIC said community banks reported net interest income of $17.5 billion during first quarter 2016, up $1.3 billion (8.2 percent) from the prior year. Net interest margin of 3.56% was up two basis points from the year earlier, as asset yields increased two basis points and funding costs were unchanged. Going forward, however, margins are projected to trend downward as asset yields are under pressure while funding costs remain near floors.

In this environment, some institutions may wish to consider a more active investment style. A number of organizations limit their investment allocation to a few areas in which they are comfortable, such as mortgage securities or agencies. With this approach, however, the institution may be sacrificing income as well as increasing balance sheet risk.

In fact, portfolio managers at many banks have been busy realigning their investment distributions. With the decline in rates in recent quarters, portfolio cash flow has spiked and according to industry reports, the destination for this cash has largely been municipal and other non-agency bullet securities.

This shift should not come as a surprise, as organizations continue to struggle with margin challenges in the face of a flatter yield curve. Depositories choose these types of securities to provide additional yield and position the portfolio more appropriately for the current rate environment. The predictable cash flow feature makes them an attractive alternative even with the longer duration.

Investment sectors often become overvalued. Investors concerned about rising rates have flocked to short-duration mortgages and floating-rate notes, driving up prices and pushing down yields. At the same time, the market tends to punish entire sectors during times of stress. In these cases, investment officers should consider selling the "rich" securities and moving into the undervalued ones.

Earlier this year, corporate bond spreads widened dramatically as energy prices fell and the stock market plunged. This affected most corporate issuers regardless of credit quality. Apple Inc., for example, issued five-year notes at a spread of 100 basis points to Treasuries, about double the normal spread. This happened in spite of Apple's strong balance sheet, consistent profitability and ample liquidity.

Investors moving out of short-duration mortgage securities and into high-quality corporate bonds at this time could have realized higher levels of current income and more stable portfolio cash flow characteristics. While corporate bonds are not appropriate for all investors, the same strategy can be utilized with other securities that offer favorable total return potential.

Maintaining flexibility for managing the investment portfolio can reduce overall rate sensitivity through a range of tactical and strategic transactions. An active manager tends to spread exposures to a variety of higher-returning sectors, while moving out of market segments that become expensive. Successful active management also entails a willingness to think independently in terms of position and sector weightings. When properly implemented, active management strategies can lessen an institution's exposure to declining margins, helping to offset the impact of a challenging investment landscape.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

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