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At The Margins

Approaching The Tipping Point

FOMC Considers When – How Much – To Raise Rates

By Robert B. Segal

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The Federal Reserve maintained its pledge to be “patient” on raising interest rates and boosted its outlook of the economy, even as it said inflation will decline further.


Robert Segal

“Economic activity has been expanding at a solid pace,” the Federal Open Market Committee (FOMC) said recently after a two-day meeting in Washington. “Labor market conditions have improved further, with strong job gains and a lower unemployment rate.” Policymakers said inflation “is anticipated to decline further in the near term,” adding that price gains are likely to “rise gradually toward 2 percent over the medium term” as transitory effects of low energy prices dissipate.

Minutes of the meeting showed that some policymakers judged that risks facing the economy justified keeping interest rates near record lows for longer. “Many participants indicated that their assessment of the balance of risks associated with the timing of the beginning of policy normalization had inclined them toward keeping the federal funds rate at its effective lower bound for a longer time,” according to a record of the Jan. 27-28 FOMC meeting.

The committee, while considering risks to be “nearly balanced,” pointed to a strengthening dollar, international flash points from Greece to Ukraine and slow wage growth as weakening the case for the first rate rise since 2006.

Most officials expect to raise rates this year and are weighing encouraging news on growth and the labor market against too-low inflation to judge the correct moment for liftoff. While the panel’s Jan. 28 statement received unanimous backing from voting members, the minutes showed diverging views over when the first increase may be appropriate.

“Some observed that, even with these risks taken into consideration, the federal funds rate may have already been kept at its lower bound for a sufficient length of time, and that it might be appropriate to begin policy firming in the near term,” the minutes said.

A Holding Pattern, For Now

Federal Reserve Chairwoman Janet Yellen, speaking before the Senate last month in her semiannual testimony about the economy, may have laid the groundwork for interest-rate increases later this year.

“The employment situation in the United States has been improving on many dimensions,” Yellen told the Senate Banking Committee. Spending and production had increased at a “solid rate,” she added, and should remain strong enough to keep bringing unemployment down. If the economy continues to strengthen as the Fed anticipates and officials become more confident that low inflation will rise toward their 2 percent goal, she said, the central bank “will at some point begin considering an increase in the target range for the federal funds rate.”

Even as the Fed has been contemplating hiking overnight borrowing costs, Treasury yields have fallen considerably over the past year. These plunging yields are sending mixed signals about the outlook for the U.S. economy. According to observers, they reflect stronger demand for U.S. assets in an uncertain global environment. At the same time, lower yields indicate concern that disinflation is deepening. The Fed’s preferred inflation gauge, the PCE price index, rose 1.3 percent in January from a year earlier and has lingered below the Fed’s 2 percent goal for nearly three years.

As interest rates fell, investors of callable agency bonds saw their expected duration plunge, a clue that many of these securities could be redeemed well before maturity. While prices of most fixed-income securities rise as interest rates decline, callable agency bonds are typically “capped” at about par, which limits a potential benefit to capital.

If the current environment holds, some investment officers will be faced with larger-than-expected amounts of cash to be reinvested. Institutions should carefully monitor projected cash flows arising from the agency segment, within the context of the overall asset liability planning process. Pre-investment strategies may make sense while deleveraging is also a consideration if suitable assets are not found.

Similar to callable bonds, bank CDs experience less price appreciation potential in a falling rate environment, reducing a possible boost to equity. Investors who have made sizeable allocations to bank CDs are finding diminished ability to take advantage of market opportunities, as well as less liquidity to fund loans.

As an example, credit union holdings of bank CDs amounted to 16 percent of total investments as of September 30, 2014 according to the NCUA, with some allocating over 50 percent of their portfolio. By comparison, banking institutions typically hold less than one percent. An institution with an excessive concentration in this sector may possess fewer options to effectively manage their investment portfolio.

Over the past year, Treasuries have been supported by shrinking budget deficits, a strong dollar and subpar economic growth. Wall Street economists still say longer-term interest rates will increase 100 basis points over the course of 2015. Whether or not their forecast is right, investors with well-structured diversified portfolios will have more flexibility to achieve their balance sheet goals in the coming year.

Robert B. Segal is president of Atlantic Capital Strategies Inc., an investment advisor located in Bedford. He can be reached at bo@atlanticcapitalstrategies.com.