RSW INVESTMENTS

Bond Investors Aren't Yielding to the Fed (12/9/15)

"To study the abnormal is the best way of understanding the normal ."–William James

It is all but a foregone conclusion that the Federal Reserve will increase the level of short-term interest rates (federal funds target rate) on Wednesday, December 16. While our "no-hike" forecast has been in place since 2009, the bond market has recently paved the way for a policy change by the Fed.

Why does the bond market matter? In 2007, RSW introduced the concept that the Federal Reserve's rate decisions do not lead the bond market, but instead follow. Specifically, it has been our contention that the Fed's decision to alter the level of the funds rate is dictated by the yield of three month U.S. Treasury Bills.

As you will note in **Chart A** below, three month U.S. Treasury bill yields have historically been the first to adjust to changing economic conditions. The Fed watches the U.S. Treasury bill market, and then contemplates whether or not it is appropriate to move the funds rate accordingly. By focusing in on recent market activity (**Chart B**), you will note that three month U.S. Treasury bill yields have surged since October. Having spiked to a recent high of 27 basis points, the bill market has provided Yellen and company with ample room to shift the funds rate toward that level.

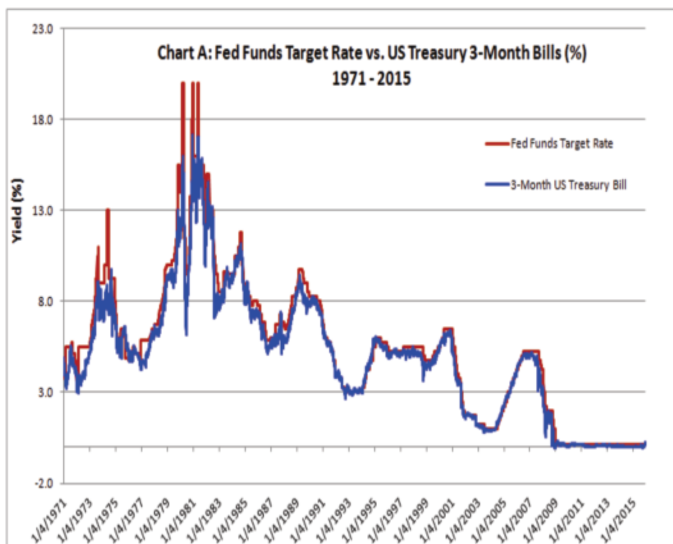

CHART A

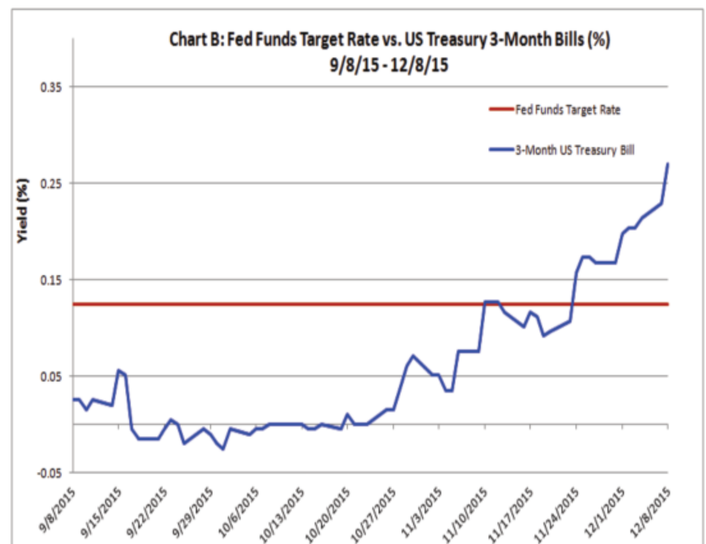

CHART B

Observations:

- Never in the history of the Fed have they hiked the Funds rate when economic activity is slowing and/or the pace of inflation is receding.
- Slower growth and deflationary forces are a global issue. Approximately 40% of all outstanding European sovereign debt is trading at negative yields.
- Against this backdrop, Fed Chair Janet Yellen is talking about the "normalization" of the Federal Reserve interest rate policy.

- Either the Fed is on the verge of taking action to show us that they can, or to make room for the next emergency.
- The Treasury bond market is already voting on the wisdom of a rate hike.
- Ten year U.S. Treasury bond yields have declined from their recent highs, at the same time that three month U.S. Treasury bill rates have climbed.
- It is important to note that the Federal Reserve only controls the level of short term interest rates. Expectations of future economic activity and inflation expectations drive the market yields on longer maturity bonds.

Is it abnormal behavior to attempt to cure what low rates couldn't by hiking rates, while mentioning stronger economic activity and inflation that is actually decelerating?

More to follow, as RSW is planning to release the 2016 Outlook next week.

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