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INSIGHTS: FED TALK | WEBINAR SUMMARY

Views and Implications for Fixed Income Portfolio

Our fixed income portfolio managers discussed the Fed's FOMC meeting of November 2–3, how it impacts our current views and implications for fixed income portfolios.

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Steve Boothe, CFA
Head of Investment Grade and Portfolio Manager

Chris Brown, CFA
Head of Securitized Products and Portfolio Manager

Stephen L. Bartolini, CFA
Core Bond Portfolio Manager

The Fed Appears to Lean Dovish vs. Market Expectations

- Steve Bartolini, Core Bond portfolio manager, remarked that the Fed came across as "not hawkish" due to what was laid out before the meeting by the other central banks.
- Bartolini elaborated that the Fed is leaning dovish and trying to be patient because they believe that they're buying time for bottlenecks, shortages, and supply-induced inflation to come down. By not announcing a taper schedule, it gives the Fed some degree of freedom to act in case they need to adjust that view.
- Chris Brown, head of Securitized Products and portfolio manager, explained that the Fed has a dual mandate, as opposed to other central banks, consisting of price stability and maximum employment.
- Currently, Fed Chairman Jay Powell and the Fed seem to be primarily focused on the latter: maximum employment. While inflation is not necessarily where they want it to be, Brown believes that the Fed has a pretty good idea that this will ease down the road, so they can focus right now on the employment part of the mandate.

This Isn't Your Typical Phillips Curve Inflation

- In terms of whether this inflation is transitory or more episodic, Steve Boothe, head of Investment Grade and portfolio manager, believes that on a short-term basis, inflation is going to be fairly high.
- Brown chimed in to remark that he believes that, beyond the second half of next year, today's inflation is going to moderate. Relative to history, especially after the global financial crisis, inflation will be elevated, but he adds that this is healthy and ultimately what the Fed is trying to achieve.
- From Bartolini's perspective, in our present day "COVID world," we have a supply deficiency, which is a much different dynamic than what we had previously. With supply deficiency, supply-side inflation is so high, it's actually lowering the ability for the economy to grow. He added that when this rectifies itself, it will put the overall economy in a more comfortable macro position.

Chair Nominations: Either Powell or Dovish

- In light of Chairman Powell's term ending in a few months, Bartolini thinks it's very likely he will be renominated. He elaborated that if it's not Powell, the other likely candidate is Lael Brainard, who is seen to be dovish.
- Regarding the other seats to fill and how it could potentially affect policy moving forward, Brown believes that the composition of the Fed and the core decision-making body of the Fed will stay intact and that the ideology will not shift. He agrees that it's a noncontroversial pick to keep Powell in place.
- Boothe added that one potential risk with any turnover within the Fed is on the regulatory side as opposed to the policy side. He suggested that the regulatory environment right now is probably "as clean as it gets" for banks in general. He agreed that the policy "ship" is in motion, and he wouldn't expect much to disrupt that dynamic.

A Potential Hurdle for the Risk Environment

- Bartolini explained that he'd be concerned if we get a sharp drop in the unemployment rate, which would push the Fed into a hawkish policy stance faster than anticipated. A drop like this could be possible without a corresponding response in labor force participation by the prime age working groups (24 to 55 years old).
- Powell had mentioned that they look at a broad scope of employment indicators, but considering that some data are only available quarterly, they can't really make a full judgment on the employment rate for at least a couple months.
- Brown added that we need to watch the labor force participation rate. He mentioned that Powell has emphasized multiple times that today's unemployment rate of 4.8% is not representative because of the low participation rate.

Fixed Income Portfolio Positioning: Today and Moving Forward

- Brown commented that that in his portfolio, total risk, or tracking error volatility, has come down substantially since the beginning of the year, which initially focused more on the reflation trade.
- Brown did add that his portfolio has tilted to a recovery, or mini-reflation, type of portfolio. He has been shifting duration shorts into the 10- and 30-year part of the curve because, in his words, "the curve is kind of where the action is."
- From Bartolini's perspective, the chance of the curve steepening is high in the short term but once you get inside of a year before the first rate hike, the trend tends to present itself as a flattening curve. That probably doesn't become too impactful for a couple months, but it is where he differs slightly from Brown in that he's on watch for the curve itself, which is a much higher-conviction call for the portfolio he manages.
- Boothe added on the credit side of things, he would have run less beta in the portfolio today, relative to early 2021 given current valuations and flatness of quality curves. One way to implement this would be to take less structure risk, for example, by owning fewer subordinated securities. However, he is still willing to take curve risk out the credit curve, particularly in the intermediate portion.
- The biggest difference in Boothe's current view relative to earlier this year is on the dollar. While many were running dollar shorts earlier this year, that is happening less so now. Typically, you would expect the dollar to move lower under conditions like a steeper curve and higher rates, but that is not the case here. If the dollar remains where it is, or even migrates a bit higher, that may be a signal to watch your risk levels as you move into the early part of next year.

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