Fixed Income Market Commentary

December 2015

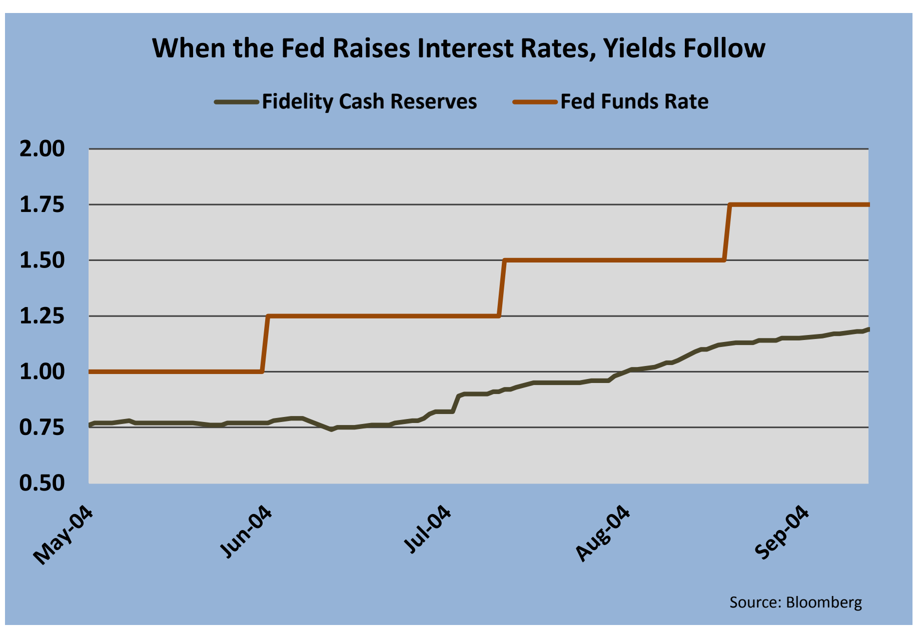
Scratching the Seven Year Itch

Seven years ago to the day, the Federal Reserve, then led by Ben Bernanke, lowered the short-term fed funds target rate to a range between 0.00% and 0.25%. That move ushered in what has been called the ZIRP or zero interest rate policy that has bedeviled savers and income investors alike.

Today the Fed, now chaired by Janet Yellen, declared that the ZIRP is over by raising the fed funds rate to a range of 0.25% to 0.50%

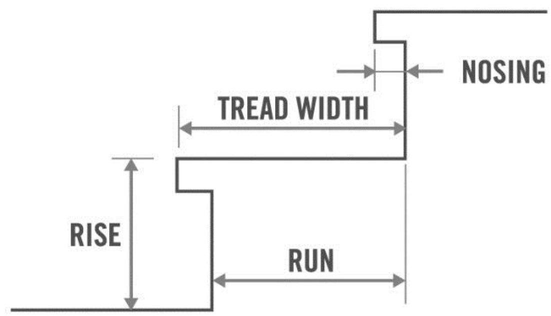
So what does this mean for bond investors? To begin with, investors should view this as welcome news! We've waited a long time for higher bond yields and the results of today's action should lead very quickly to higher payouts for short-maturity bonds and cash accounts.

If you have cash at the bank or in money market funds, you will be among the first to benefit. A quick review of the last time the Fed began raising interest rates shows how quickly Fidelity's Cash Reserves Money Market Fund responded. The graph below plots the first three legs of the Fed's policy shift to higher interest rates that began in June 2004. You can see that the yield on Fidelity Cash Reserves rose almost in lockstep with the Fed's actions. It's reasonable to anticipate proportional moves this time around as the market responds to the Fed's action though, as I'm sure you're aware, we're starting from a much lower initial yield.



The debate now shifts from "when" to "how many" interest-rate increases we are likely to see, and over what time frame.

While some pundits have suggested the Fed's action will be "one and done" I think we can expect another move higher at one of the next two Fed meetings in late January or mid-March. Subsequent to that, the stair-step pattern of rising interest rates should be extremely shallow, with small increases followed by long periods of watching and waiting. (In homebuilding terms, the riser will be extremely small and the tread extremely wide.)



Federal Reserve rate increases will follow a "short riser, wide tread" pattern in the months to come.

Even after today's hike, interest rates remain extremely low or, as economists like to say "highly accommodative." This means consumers and businesses continue to be able to borrow money cheaply, fostering an environment that should help extend the economy's expansion.

For investors, this is not the time to sit on the sidelines waiting for rates to rise further. While the short-term implications of a rate hike are usually a decline in bond prices, investors should be quickly compensated by those higher yields.

Rather than wait for the Fed to finish its sequence of fed funds rate increases— something we won't know about until after the fact, investors should concentrate on those areas of the bond market that are likely to benefit first. Bonds with short to intermediate maturities— an area where I have been focusing my attention for a while now—will be the first movers after money market funds. Investors should consider initiating a position or adding to existing ones (dollar-cost-averaging works for both stock and bond investments).

Yes, bonds still have an important role to play in a diversified portfolio. As interest rates were falling to record lows these past several years, some investors questioned the wisdom of maintaining a portfolio allocation to fixed-income investments. Wisely, most stayed the course because they knew that bonds, even with low yields, play a crucial role in reducing portfolio volatility, generating income and maintaining a store of dry powder in the event of an unexpected call for cash.

I welcome the Fed's action because it means we will all begin earning more on our cash and short-term bond holdings. While significantly higher interest rates and rates of return are not on the immediate horizon, we are on our way.

Rest assured that I will be taking every advantage I can to ensure that some of that additional yield finds its way into your portfolio.

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