

Market Insight

Fed Holds Steady

The Federal Reserve opted to leave its short-term interest rate target unchanged near zero following the September gathering of its policy-making Federal Open Market Committee (FOMC). Though the central bank cited moderate expansion in the domestic economy, it expressed concerns that “recent global economic and financial developments” may restrain economic activity somewhat and could put further downward pressure on inflation in the near term.

The FOMC announcement was more or less in keeping with market expectations; as of this morning the futures market was pricing in only a 25% likelihood of a federal funds rate hike at this meeting. Markets had ascribed a 45% chance of a hike as recently as a month ago before a turbulent August — highlighted by a currency devaluation in China that heightened concerns about global economic growth and led to a sharp selloff in risk markets worldwide — sent expectations for a Fed move lower.

Messaging from the central bank remained generally dovish. Due in part to lower oil prices and a stronger dollar, Fed officials do not expect inflation to reach the central bank’s 2% objective until 2018; core PCE, the Fed’s preferred inflation metric, grew only 1.2% in July from a year earlier. The central bank has also reduced its expectation for the economy’s long-run growth potential, to 1.8–2.2% from 2.0–2.3% previously. That said, a large majority of the 17 FOMC members still believe the central bank will introduce a rate hike at one of the two remaining 2015 policy meetings, though the number slipped to 13 in September from 15 in June. Following the Fed announcement, futures traders were pricing in a 21% probability of a rate hike in October and a nearly 50% chance in December.

Notably, after five consecutive unanimous policy statements, September’s statement featured one dissenter: Jeffrey Lacker, president of the Richmond Fed, preferred a 25 basis point hike. Also notable is that for the first time ever a Fed official moved his or her policy rate forecast — one anonymous dot in the so-called “dot plot” — into negative territory; during the press conference, however, Chair Yellen said negative rates were not “something we seriously considered.”

With the financial crisis in full swing, the Fed cut its target federal funds rates to near zero in December 2008 in an attempt to stoke lending to consumers and businesses and revive the economy. This was the last of a series of rate cuts that took the target rate from 5.25% to its current 0–0.25% level in a mere 16 months. Rock-bottom interest rates were accompanied by massive asset purchases — aka quantitative easing — that added more than \$3.5 trillion to the central bank’s balance sheet before the last bond was bought in October 2014.

We asked the leaders of our four investment platforms for their thoughts on the Fed’s announcement.

Equity

With the Fed opting to leave its target rate unchanged, the same risks and opportunities persist in the equity markets. Global growth remains uncertain, and domestically we’re concerned about corporate earnings growth. Earnings — likely to hit another all-time high in 2015 — have been driven in large part by rigorous expense management and the utilization of corporate finance measures like stock buybacks, and are vulnerable without better support from top-line revenue growth. Meanwhile, those stocks that have been able to generate top-line growth have become crowded, leaving them susceptible to wild swings in investor sentiment should their metrics disappoint. Our equity strategies are built through rigorous bottom-up research combined with disciplined portfolio construction, which we believe allows us to perform well in a variety of market environments.

Fixed Income

Given significant gyrations in China and other emerging markets in recent weeks, the Fed’s decision to remain on hold was reassuring to markets and investors. The Fed took a big step by explicitly linking the impact of global economic and financial markets with domestic inflation and inflation expectations. The recent disruption in global markets has tightened financial conditions and slowed economic activity, which will keep downward pressure on inflation and allow the FOMC to remain extremely accommodative.

We think fixed income markets will take the announcement somewhat positively, although the reaction will be modest. The Fed has a short window of time in which to hike this year, and that window is closing; with the inflation outlook heading south, reasons for a 2015 rate increase have grown even less compelling. In terms of positioning, we like staying long duration in the U.S. and slightly short the U.S. dollar.

Multi-Asset Strategies and Solutions

Overall, we expect the Fed to stand on the sidelines until first quarter 2016 as it closely monitors data flow. We agree with futures markets that the Fed is unlikely to move in October, as there is no scheduled press conference, and we think a December hike is also unlikely given the importance of the year-end shopping season. The Fed statement points to slower growth coming from “recent global economic and market developments” and that measures of “inflation compensation have moved lower.” Slower growth combined with a lack of wage pressures means that inflation risks are pushed off, allowing the Fed to be patient. While the Fed does note that it is “monitoring developments abroad,” we don’t take that to mean that the central bank is making policy decisions based on its China outlook.

Rates holding near zero should give some support to risk assets, though concerns about a soft global economy may act as a headwind for global equities. We would expect to see a modest steepening of the U.S. yield curve, a stable dollar around current levels and some support for commodity prices. The Fed's delay combined with continued easing by the European Central Bank and Bank of Japan is a net positive for global liquidity, which should help stabilize emerging market equities. Still, we would expect there to be market volatility around the economic outlook in emerging markets and, more important, in the U.S. until the Fed's intentions become clearer.

Senior Loans

With Fed rate policy unchanged, at least for the near term, there is little direct impact expected for the senior loan asset class. We believe it's likely that retail loan fund flows will continue to vacillate as they have for the last six months, with occasional interest in the asset class. It is unlikely we will see a distinctive move toward a consistent, positive allocation from retail investors until a rising-rate environment is officially in play. Institutional investors, on the other hand, should be unmoved by today's statement, as they have for some time been positive on the asset class (both via collateralized loan obligations and other non-CLO institutional accounts and funds) and the low volatility and risk-adjusted returns that loans currently provide, without regard to any imminent potential of a change in Fed policy.

At this point, we believe it's likely that Fed policy will remain unchanged for the duration of 2015, with the first move potentially considered for first quarter 2016.

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