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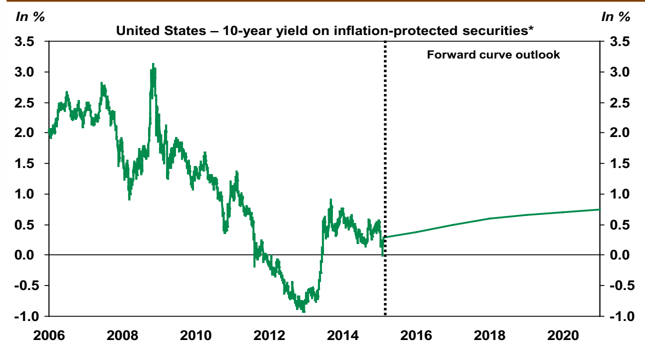
A new conundrum for the Federal Reserve?

The Federal Reserve (Fed) is confronted with a dilemma that may have been unexpected at the time of crafting exit strategies just a few years ago. Here we are with an economy and job market that have convincingly transitioned to a speedier trajectory, yet long-term bond yields remain stubbornly low. Granted that the impact of falling energy prices on inflation expectations explains a good part of the phenomenon, but real yields remain remarkably low considering the improving economic outlook in the United States. In fact, if one reads into the signal from forward markets, real interest rates, even at a maturity of ten years, will barely increase in coming years, and will not reach pre-crisis levels over the medium-term horizon.

Investors don't expect much of a normalization in real yields



* Treasury Inflation Protected Securities (TIPS).
Sources: Bloomberg and Desjardins, Economic Studies

Markets are thus sending a number of messages. First, the Fed's rate hikes ambitions do not seem to be taken seriously. FOMC officials expect the federal funds rate to have been lifted by 100 basis points by the end of this year. By contrast, federal funds futures fail to price such a degree of tightening until the third quarter of 2016. Second, after years of relentless efforts by the Fed to maintain its hold on rates through the entire curve, it appears markets don't see fit to request a higher compensation for the risk of locking in money in bond instruments over the long run. This compensation is known as the term premium. Under normal circumstances, at the dawn of a monetary tightening cycle, the increase in the term premium contributes to lifting yields, but this is not observed currently. Third, low yields could reflect the expectation of sustained international demand for U.S. bonds, in a context of quantitative easing policies that will extend over several quarters or even years, in Europe and Japan.

The rate normalization soon to be initiated by the Fed could put an end to a certain inertia of expectations, and thus restore the transmission channel of monetary policy throughout the curve. However, an alternative scenario where long-term rates remain nearly insensitive to a rise in short rates is not unthinkable. A similar situation was observed in the middle of the last decade, bringing the Fed chairman at the time, Alan Greenspan, to talk of a conundrum. In the current setting, even minimal policy rate increases could result in an inverted yield curve, should long-term rates fail to follow along. Among many issues, an inverted curve would have a negative bearing on bank profitability and plausibly discourage lending to households and businesses.

Implications: Apathetic long yields could constitute a complication for the Fed. Ultimately, it could consider reducing its holdings of long-term bonds to ensure the transmission of its policy to the entire curve. However, it would need to proceed with extreme care to avoid setting off an overly abrupt adjustment in long rates, susceptible of further hampering a still fragile housing market recovery and cause further appreciation of the U.S. dollar. Needless to say, the rate normalization process could bring with it a number of headaches for FOMC officials.

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