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Investment Analyst

How a Shrinking Federal Reserve Balance Sheet Will Affect Bonds

- We expect the Fed to announce asset reduction in September.
- This may push 10-year Treasury yields higher over time.
- We estimate that impact could be 20 to 40 basis points.
- However, long-term yields should remain anchored.

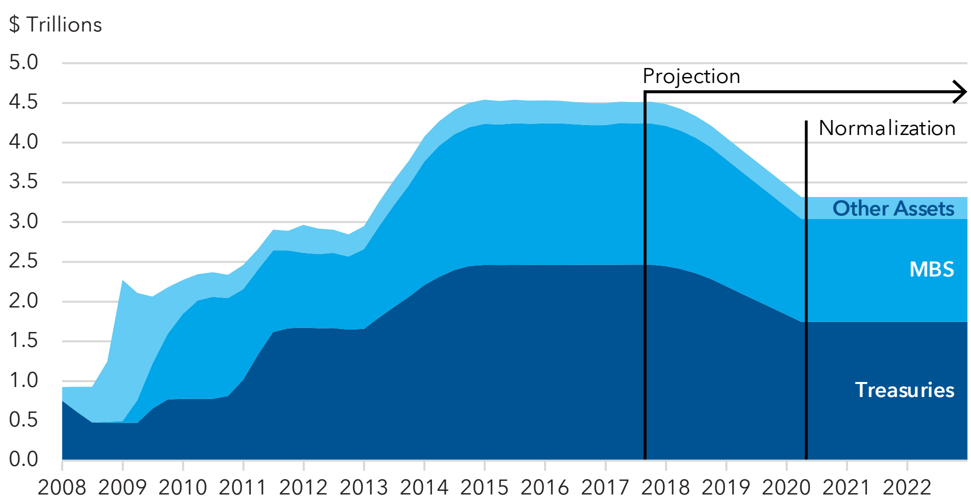
The Federal Reserve employed numerous tools in response to the 2008 financial crisis. With its policy normalization underway, its next move could be the most important yet. It will soon begin shrinking its balance sheet, allowing longer term yields to drift higher.

How This Move May Affect Markets

The Federal Reserve is widely expected to begin reducing its balance sheet over the next few months. This marks a major policy change that could impact interest rates and markets more broadly.

Long-term interest rates could move higher over the medium-term as the Fed starts to shrink its asset holdings. However, the magnitude of the rise may be modest. Our fixed income interest rates team estimates the impact on 10-year Treasury yields could be 20 to 40 basis points over time, which is consistent with projections provided by the Treasury Borrowing Advisory Committee. This estimate is based on the assumption that the broader macroeconomic environment will not shift significantly.

The Federal Reserve Balance Sheet



Sources: Federal Reserve, U.S. Treasury. As of 6/30/2017.

Multiple Perspectives. One Approach.®

"Once initiated, we anticipate tapering will operate in the background on auto-pilot as outlined by the Fed."

Although higher yields impact bond prices, significant losses can be avoided by most fixed income investors, particularly those who rely on managed bond funds that can benefit from reinvesting in higher yielding securities, as well as from duration management.

In any case, rate normalization is well underway, with the Fed having raised its policy rate four times since late 2015. This has boosted the Federal Funds rate to a range of between 1.00 and 1.25%. Nevertheless, 10–year Treasury yields have remained mostly in the range of between 1.40% and 2.60% over this period and were hovering around 2.25% at the end of August. Given relatively tame inflation and a modestly growing economy, we expect long-term interest rates to remain range-bound.

When Will the Fed Begin Its Program?

In the Fed's June 2017 meeting, it outlined its intention to gradually taper, or reduce, the reinvestment of principal payments from maturing securities. Its July meeting minutes indicated that monetary policymakers were ready to begin this program "relatively soon." This and other clues lead us to believe that it will announce in its September meeting that balance sheet reduction will begin on October 1, 2017. Once initiated, we anticipate tapering will operate in the background on auto-pilot as outlined by the Fed provided there are no major shocks to the economic recovery.

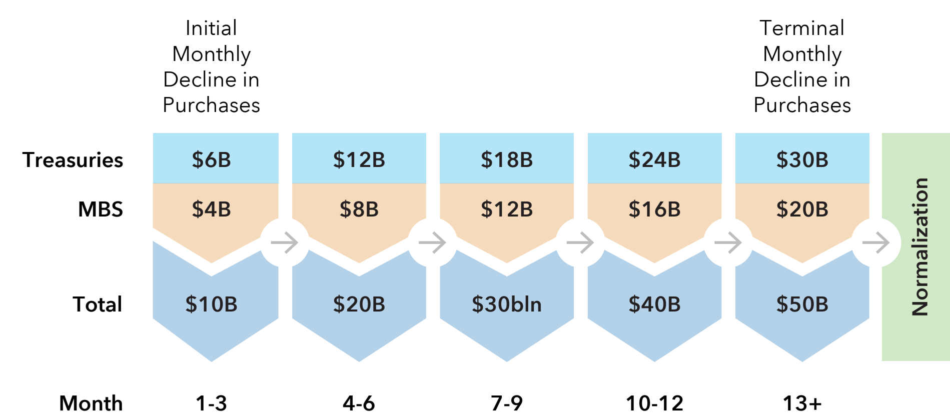
Mortgage-backed securities may be vulnerable to the Fed tapering. Although MBS have already felt some impact given tapering expectations, and having cheapened earlier this year against Treasuries, additional uncertainty on the impact of reduced Fed purchases could weigh on this sector.

How Will the Fed Reduce its Balance Sheet?

The Fed will structure this reduction by capping the amount of proceeds it reinvests from maturing securities, starting at $10 billion per month, with a 60–40 split of Treasuries and mortgage-backed securities, and gradually increasing the cap over the year to a total of $50 billion. That terminal principal reinvestment reduction will remain in place until the size of the balance sheet is normalized. While unlikely to fall all the way back to its pre-crisis size of $1 trillion, we expect the balance sheet to normalize at around $3.3 trillion from a high of over $4.5 trillion.

This policy change represents a major step for the Fed. However, with a potentially modest impact on rates over time, investors in well-managed bond funds shouldn't feel a dramatic impact.

How the Federal Reserve's Balance Sheet Tapering Plan Will Work



David Bradin
Investment Specialist

Investment-Grade Corporates: A Bridge Between Equities and Bonds

- High-quality corporate bonds are a core bond strategy.
- They can provide more income than government-backed bonds.
- Research-driven corporate bond funds have advantages.

In the recent market rally that has been characterized by a risk-on sentiment across most asset classes, investors have gravitated to high yield and leveraged bank loans or income strategies with a heavy allocation to these extended sectors of the market. As we approach the late stages of this market rally, we think it is appropriate for investors to take a fresh look at their credit exposure.

The Role of Corporate Bonds in a Portfolio

We believe that investment-grade corporate bonds provide an attractive risk-return trade-off as a core bond fund allocation. On a long-term, secular basis, prudently managed corporate bond funds can play an important role in portfolios. Corporate bonds have historically provided income, diversification from equity holdings, as well as principal preservation.

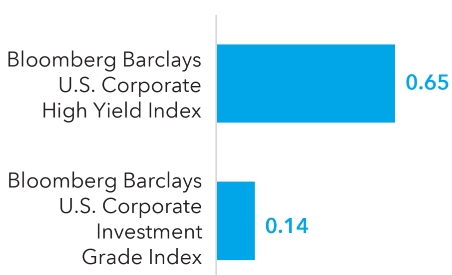
The relationship between return and volatility can be illustrated through an efficient frontier chart. Although investors can tack on higher average returns with asset classes like high yield or emerging markets, these bonds make for poor portfolio stabilizers when economic shocks hit.

This chart uses indices to show that investors looking purely for stability could do even better with core bond funds that focus on government bonds like Treasuries. However, these strategies provide weaker returns than well-run investment-grade corporate bond funds. Although investors do sacrifice some stability to achieve higher returns through IG corporates, the group still exhibits a relatively low standard deviation compared to other higher yielding asset classes.

Lower Correlation Than High-Yield Bonds

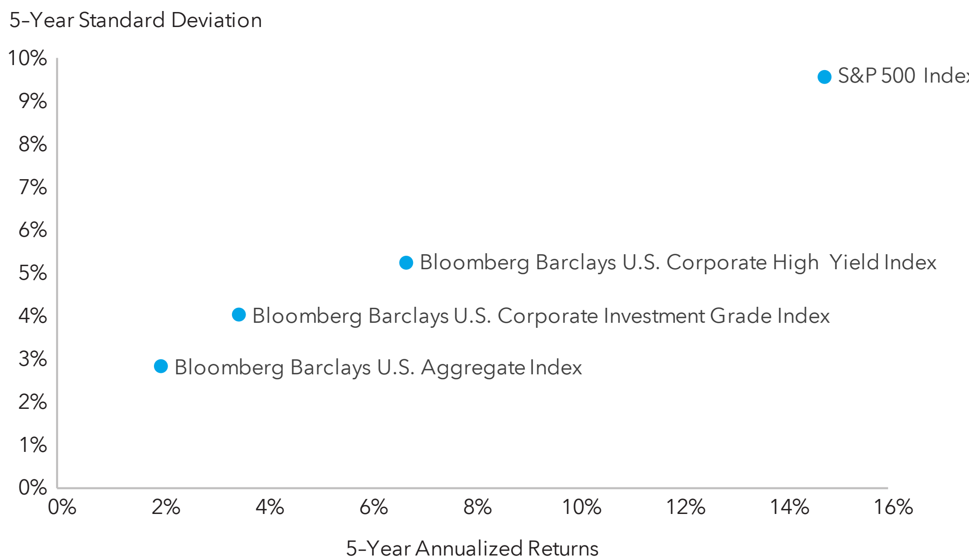
High-yield bonds had a correlation of 0.65 to the S&P 500 Index over the past five years, while investment-grade bonds had a correlation of just 0.14.

5-Year Correlation to S&P 500 Index



Source: Bloomberg Index Services Ltd.
As of 6/30/2017.

Efficient Frontier



Source: RIMES. As of 7/31/2017.

"Managers assessing individual securities can take advantage of this dispersion to identify the most attractive investment opportunities on a risk-adjusted basis."

The Research Advantage

U.S. investment-grade corporate bonds are historically an under-researched asset class. This provides an opportunity for managers like Capital Group who use deep fundamental research. The IG corporate market has matured and become much more liquid, with a market capitalization of $5 trillion and over 1,000 issuers. This allows investors to build well-rounded, diversified corporate bond portfolios.

But that is highly dependent on strong credit selection. While credit quality is high across the asset class, a dispersion of returns occurs across issuers, sectors and ratings. Managers assessing individual securities can take advantage of this dispersion to identify the most attractive investment opportunities on a risk-adjusted basis.

Passive Pitfalls

In contrast, since fixed income indices are market-value based, the most indebted issuers within each asset class are the most heavily weighted issuers. Thus, relying on passive index-based strategies means that investors are more exposed to the market's most indebted issuers.

Managers assessing individual issuers can avoid this passive pitfall by investing in debt that provides adequate risk-based returns based on issuers' capital structures, and can capitalize on relative value opportunities they identify in the market.

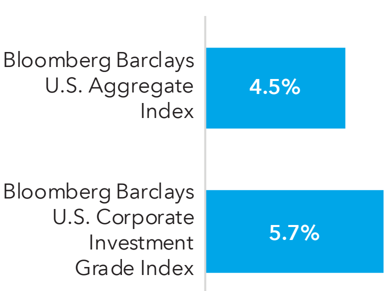
Passive strategies also require new issuance to be included in the index, while managers can invest selectively based upon an issuer's merits. Passive index-based strategies must rebalance based upon changes in market valuations, potentially requiring buying when prices are high or selling when prices are low; in contrast, managers who rely on research, buy and sell based on relative value.

U.S. IG bonds are a core asset class, providing income, diversification from equity and principal preservation. Long-term investors to the asset class have the potential to receive higher income than a government bond-driven core fund, and are less exposed to volatility than they would be in a high-yield focused multisector bond fund. An allocation to an IG corporate bond fund can improve the risk and return profiles of investors' broader investment portfolios.

Higher Returns Than Government-Driven Core Bonds

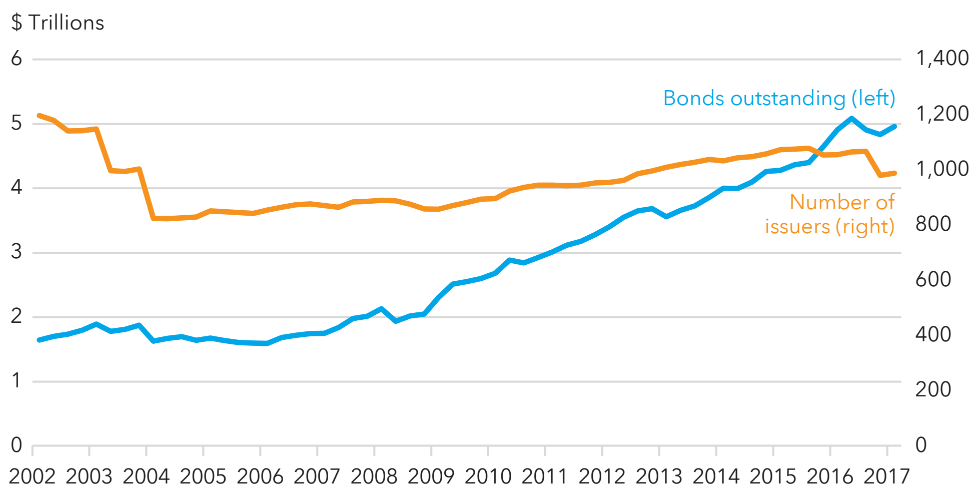
Investment-grade corporate bonds provided an annualized return of 5.7% over the past 15 years, while core bonds returned just 4.5%.

15-Year Annualized Return



Source: Bloomberg Index Services Ltd. As of 6/30/2017.

Growth of U.S. Investment Grade Corporate Market



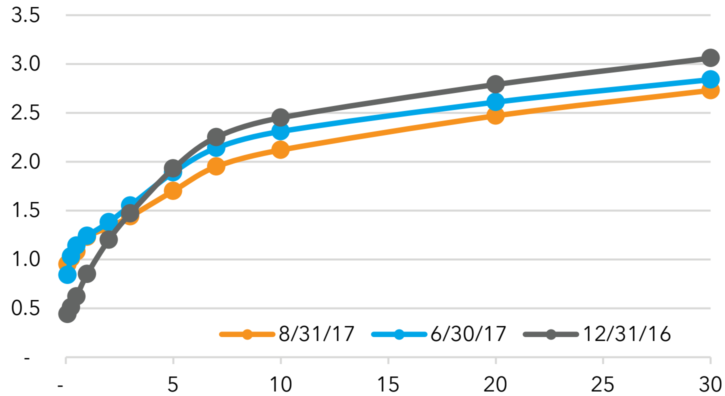
Source: Bloomberg Index Services Ltd. As of 6/30/2017.

Markets at a Glance (as of August 31, 2017)

U.S. Treasury Yields (%)

	Month-End	Quarter-End	Year-End
3-Month	1.01	1.03	0.51
2-Year	1.33	1.38	1.20
5-Year	1.70	1.89	1.93
10-Year	2.12	2.31	2.45
30-Year	2.73	2.84	3.06
2- to 10-Year Spread (bps)	79	93	125
2- to 30-Year Spread (bps)	140	146	186

U.S. Treasury Yield Curve (%)

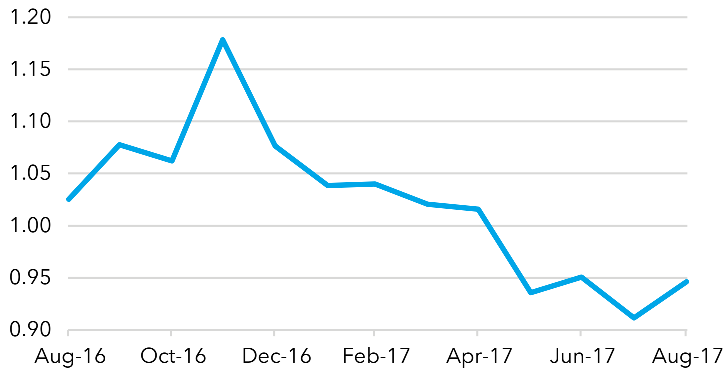


Sources: Federal Reserve, Thomson Reuters.

AAA Municipal Yields (%)

	Month-End	Quarter-End	Year-End
1-Year (1-2)	0.89	1.07	1.25
3-Year (2-4)	0.99	1.20	1.53
5-Year (4-6)	1.17	1.40	1.85
7-Year (6-8)	1.43	1.62	2.08
10-Year (8-12)	1.77	1.93	2.35
15-Year (12-17)	2.27	2.44	2.76
20-Year (17-22)	2.50	2.65	2.92
Long Bond (22+)	2.68	2.84	3.21

10-Year Investment-Grade Munis / 10-Year U.S. Treasuries (%)



Sources: Bloomberg Index Services Ltd., Federal Reserve, Thomson Reuters.

Yields (%)

	Month-End	Quarter-End	Year-End
U.K. 10-Year Government Bond	1.08	1.19	1.24
Germany 10-Year Government Bond	0.29	0.47	0.11
Japan 10-Year Government Bond	0.01	0.09	0.05
Bloomberg Barclays U.S. Corporate	3.07	3.19	3.37

Exchange Rates (% Change vs. USD)

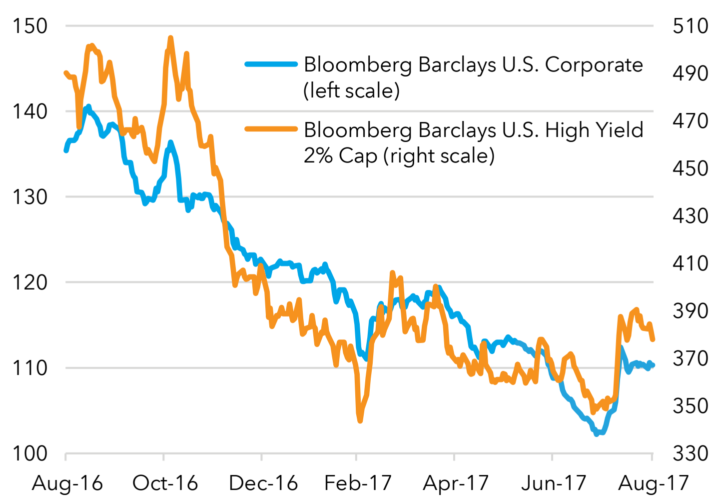
	1-Month	3-Month	YTD
British Pound	-2.26	-0.19	4.28
Swiss Franc	0.40	0.68	5.76
Euro	0.84	5.73	12.72
Japanese Yen	0.40	0.48	5.97

Fixed-Income Index Returns (%)

	1-Month	3-Month	YTD
Bloomberg Barclays U.S. Aggregate	0.90	1.23	3.64
Bloomberg Barclays Global Aggregate	0.99	2.60	7.22

Sources: Bloomberg Index Services Ltd., Federal Reserve, RIMES, Thomson Reuters.

U.S. Corporate Spreads (bps)



Source: Bloomberg Index Services Ltd.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing. The material must be preceded or accompanied by the American Funds Emerging Market Bond Fund prospectus. Securities offered through American Funds Distributors, Inc.

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