# Legg Mason Portfolio Managers Respond to Federal Reserve Rate Hike

*Long-Expected Move Represents First Step Toward Normalizing U.S. Bond Markets – But There Are Risks If Fed Goes Too Far, Too Fast*

**(New York, NY, December 16, 2015) –** This morning's move by the U.S. Federal Reserve (Fed) to raise interest rates was expected by Legg Mason's bond managers. They believe this first step should restore "normalcy" to bond markets and prove advantageous to investors.

"The Fed did exactly what everyone expected," said John L. Bellows, Ph.D, a Portfolio Manager and Research Analyst with Western Asset Management. "The markets were ready. The 25 basis point hike was already priced in. Had they not raised it would have been very confusing to the markets, given the fairly clear communications they had been providing. But they delivered."

"The Fed was very clear about their desire to start the rate hiking cycle. They recently lowered the bar aggressively for what they needed to see to justify hiking. The economic data over the last few months, while not great, cleared the Fed's very low bar."

Francis A. Scotland, Co-Director of Global Macro Research and Portfolio Manager of Global Macro Strategy for Legg Mason affiliate Brandywine Global, acknowledged that markets anticipated the hike. However, he believes the Fed should not have been in any rush to raise rates, as inflation expectations did not justify liftoff.

Mr. Scotland explained, "The Fed made its rationale clear: the unemployment rate has fallen to a level normally associated with upward pressure on wages, which the central bank believes will spur price inflation back to target. Many Board members believe zero interest-rate settings are appropriate only in the context of a financial crisis, so rates should move, since there is no longer a crisis."

Today's quarter-point rise is only the beginning of what most market watchers expect will be a steady rate climb away from zero by the Fed – which appears to be in no particular rush.

"Everybody has heard the Fed's insistence that the rate hiking cycle will be 'gradual,'" Mr. Bellows commented. "That word has shown up in pretty much every Fed speech all year. We take the Fed at their word regarding a 'gradual' pace, not necessarily because the Fed always does what they say – far from it! – but because our economic outlook doesn't suggest any reason for the Fed to do anything else. We expect inflation to remain low, and growth may downshift slightly after a number of steady two percent years. The Fed has no reason to be aggressive."

The Western Asset team believes the Fed's process may not be pursued in lock-steps.

"Recent FOMC forecasts had four hikes in 2016, once per quarter," Mr. Bellow said. "We expect they will hike at a somewhat slower pace, likely skipping at least one quarter. The Fed does not want to be overly predictable, which Chairman Greenspan was criticized for in the 2004 cycle. The obvious way to deviate from a mechanical hiking path is to skip a quarter."

"The March meeting is probably too early, but perhaps in June or September, when it will be more clear that growth and inflation are coming in under the Fed's expectations."

Mr. Scotland and the Brandywine Global team cautioned that the Fed should not rush to raise interest rates. They see several potential pitfalls that could cause significant economic damage.

“Collapsing commodity prices and rising credit spreads usually spurs the Fed to ease,” Mr. Scotland said. “The Fed has dismissed these developments, relating them to the shakeout in energy and temporary effects of a strong dollar. To us they are important risk factors warning against a premature lift off. The business cycle is still not normal and profit growth is stagnant.”

“The risk is that the rate increase proves premature and subsequent hikes go too far, too fast. The world economy has been slowing steadily since early 2014, with signs of deflationary pressure. Last year the dollar rose faster and further than any comparable period since the float. It has contributed to wider credit spreads, falling commodity prices and a manufacturing recession.”

“Add that every other major central bank in the world is stimulating,” Mr. Scotland said. “The European Central Bank (ECB) appears ready to pull out all the stops to drive inflation higher and the euro lower. The Bank of Japan continues its massive balance sheet purchases of government bonds and equity-linked exchange-traded funds. The People’s Bank of China has implemented rate reductions and lower reserve requirements. The ECB has warned of a rapid repricing of global risk premia, particularly in emerging markets, if the Fed raises rates faster than expected.”

Yet against this backdrop, the case for fixed income remains compelling to Brandywine Global.

“Treasury yields look likely to remain low for a long time in the future,” Mr. Scotland said. “Flatter EM currency profiles should pave the way for lower inflation rates in these countries, easier monetary policy and significantly lower bond yields. The case for spread compression between the emerging fixed income world and the developed world is strengthening.”

To counter these risks, Mr. Bellows suspects that the Fed may become truly data dependent.

“With the notable exception of the unemployment rate, U.S. economic data is not that different than earlier this year,” he said. “Inflation is still well below target, wage growth is stagnant, GDP growth is no more than two percent, and the dollar is still increasing. Yet even though the U.S. economic picture is weak – especially on the inflation side – the Fed proceeds with rate hikes.”

“It’s debatable whether this counts as data dependent, but we suspect that the failure of inflation to pick up will become more of a binding constraint on the Fed in 2016. This is the primary reason we expect the Fed will not get to four hikes next year.”

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**About John L. Bellows Ph.D**

John Bellows joined Western Asset Management in 2012 as a portfolio manager/research analyst. From 2009 to 2011 he served in the U.S. Department of the Treasury in three capacities: Acting Assistant Secretary for Economic Policy; Deputy Assistant Secretary for Microeconomic Analysis; and Senior Advisor in the Office of Economic Policy. Mr. Bellows earned a Ph.D. in economics from the University of California, Berkeley, and a B.A. in economics, magna cum laude, from Dartmouth College.

### About Francis A. Scotland

Francis Scotland is Co-Director of Global Macro Research and a Portfolio Manager of Global Macro Strategy for Brandywine Global. He joined the firm in 2006. Mr. Scotland has developed a proprietary global macroeconomic research structure to support the fixed-income group's investment process. In addition to his extensive contribution to the global macro strategy, he provides investment ideas and strategic asset allocation recommendations for the firm's global fixed income and hedge fund products. Prior to joining Brandywine Global, from 1984 until 2005 Mr. Scotland was a principal of the BCA Research Group and head of global investment strategy. He also spent several years in the policy departments of the Bank of Canada in the early 1980s, working in monetary, economic and financial analysis. Mr. Scotland has a Master's degree in Economics from the University of Western Ontario in London, Canada, and an Honors B.A. in Economics from Queen's University in Kingston, Canada.

### About Brandywine Global

Founded in 1986, Brandywine Global Investment Management offers a broad array of fixed income, equity, and balanced strategies that invest across global markets. As of September 30, 2015, Brandywine Global manages $66 billion in assets. The firm is a wholly owned, independently operated subsidiary of Legg Mason, Inc., and is headquartered in Philadelphia with an office in San Francisco. Brandywine Global also operates two affiliated companies with offices in Singapore[1] and London[2].

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### About Western Asset Management

Western Asset Management is one of the world's leading fixed-income managers with $446.1 billion in assets under management as of September 30, 2015. The firm is a wholly owned, independently operated subsidiary of Legg Mason, Inc. From offices in Pasadena, Hong Kong, London, Melbourne, New York, São Paulo, Singapore, Tokyo and Dubai, the company provides investment services for a wide variety of global clients, across an equally wide variety of mandates. To learn more about Western Asset Management, please visit www.westernasset.com.

### About Legg Mason

Legg Mason is a global asset management firm with $697 billion in assets under management as of September 30, 2015. The Company provides active asset management in many major investment centers throughout the world. Legg Mason is headquartered in Baltimore, Maryland, and its common stock is listed on the New York Stock Exchange (symbol: LM).

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**Basis Point** is one one-hundredth of one percent (1/100% or 0.01%).

**Gross Domestic Product** ("GDP") is an economic statistic which measures the market value of all final goods and services produced within a country in a given period of time.

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