Rocaton

INSIGHTS

The Great Rotation? *Implications of the Recent Volatility in Interest Rates*

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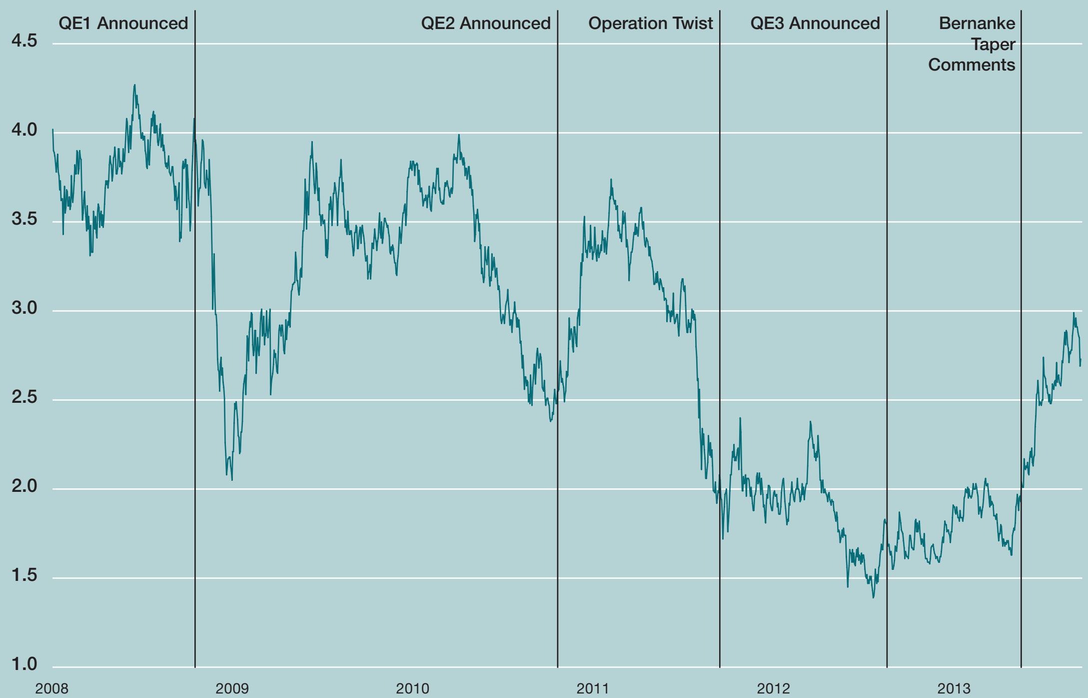
Executive Summary

Most financial market commentators have been calling for a secular rise in interest rates for several years only to find interest rates reaching new lows. Is the recent sharp jump in rates the beginning of the secular rise many forecasters have been predicting or is this just another false alarm? Providing a definitive response to this question is a difficult task. It is Rocaton's belief that interest rates will gradually move back towards equilibrium levels (e.g., 10-year Treasury yield of 4.60%), albeit with significant volatility along the way, on the basis that steady, slow growth will push rates higher. The recent rise and subsequent decline in yields highlights the volatile nature of interest rates. Notably, following Federal Reserve Chairman Ben Bernanke's "taper" comments, 10-year Treasury rates increased to 2.99% on September 5th, which represented a 136 basis point jump from a 2013 low of 1.63%. However, following the Federal Open Market Committee's statement that it would not taper bond purchases, 10-year rates fell to 2.69%. Given recent events, we believe it is important for investors to reexamine their fixed income portfolio positioning and review the appropriateness of this positioning given anticipated volatility and their intermediate and long term objectives.

How did we get here?

Ten reductions in the Fed Funds rate, three rounds of Quantitative Easing ("QE") and "Operation Twist" combined over a period of five years to rescue U.S. financial markets from the brink and bring them back to new highs. In the process, interest rates were driven to their lowest level in more than 60-years (see chart 1). Also of note is the fact that short-term rates have remained near zero since the start of the crisis, demonstrating the Fed's effectiveness in holding down interest rates at the front-end of the yield curve. The latest round of quantitative easing involves the purchase of $85 billion per month in Treasury and mortgage backed securities until the labor market improves and inflation reaches the Fed's target of 2%. As the U.S. economy has improved in recent months, markets were anticipating a slowdown in the pace of asset purchases. However, the Fed surprised markets on September 18th by stating that it would not begin slowing purchases. Once the Fed eventually reduces asset purchases and, ultimately, begins increasing the Fed Funds Rate, what impact will this have on the capital markets?

Chart 1:
10-Year
U.S. Treasury Yields
since 2008



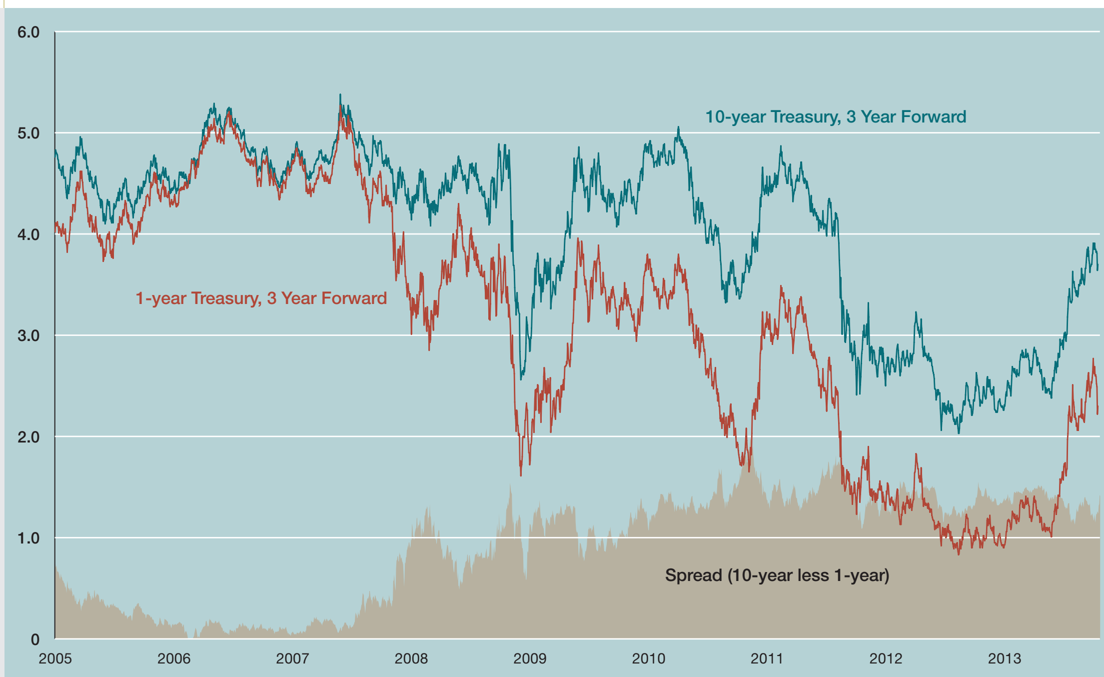
Sources: Bloomberg

What are the markets expecting?

It would be foolish to attempt to predict exactly where interest rates are headed and by when, particularly in light of the role that the Federal Reserve has played in the bond market. One reasonable and unbiased gauge of the future level of rates is the market's expectation of future interest rates or the forward curve, although this method is not without its own issues. Based on the 3-year forward curve, markets are pricing in a meaningful rise in interest rates, most notably at the short-end of the curve. As of September 18th, the 1-year Treasury bill was expected to rise to 2.22% in three years, a jump of more than 200 basis points. Expectations further out on the forward curve are more muted as the market is predicting a rise of only 95 basis points in

10-year rates and 53 basis points in 30-year rates. The meaningful spread between expectations at the short-end of the yield curve versus the expectations at the long-end signal that markets believe that long rates are approaching "fair value" while short rates have a long way to go before returning to "normal" levels. Chart 2 shows historical market predictions of rates three years forward as well as the market's forecast of the 1-10-year slope three years out.

Chart 2:
3-Year Forward Curve since 2005



Sources: Bloomberg

Lessons from 1994

Aside from examining current market expectations, market participants might be well served to reflect on the events of 1994 to gauge the impact of a potential significant Fed tightening. We certainly recognize that the economic conditions that existed in 1994 were far different from those that exist today; however what links the periods is that in both cases the rate increases were not driven by inflation fears. Reviewing the events from nearly two decades ago should provide a reminder of the outcomes that transpired during a time period when interest rates rose meaningfully.

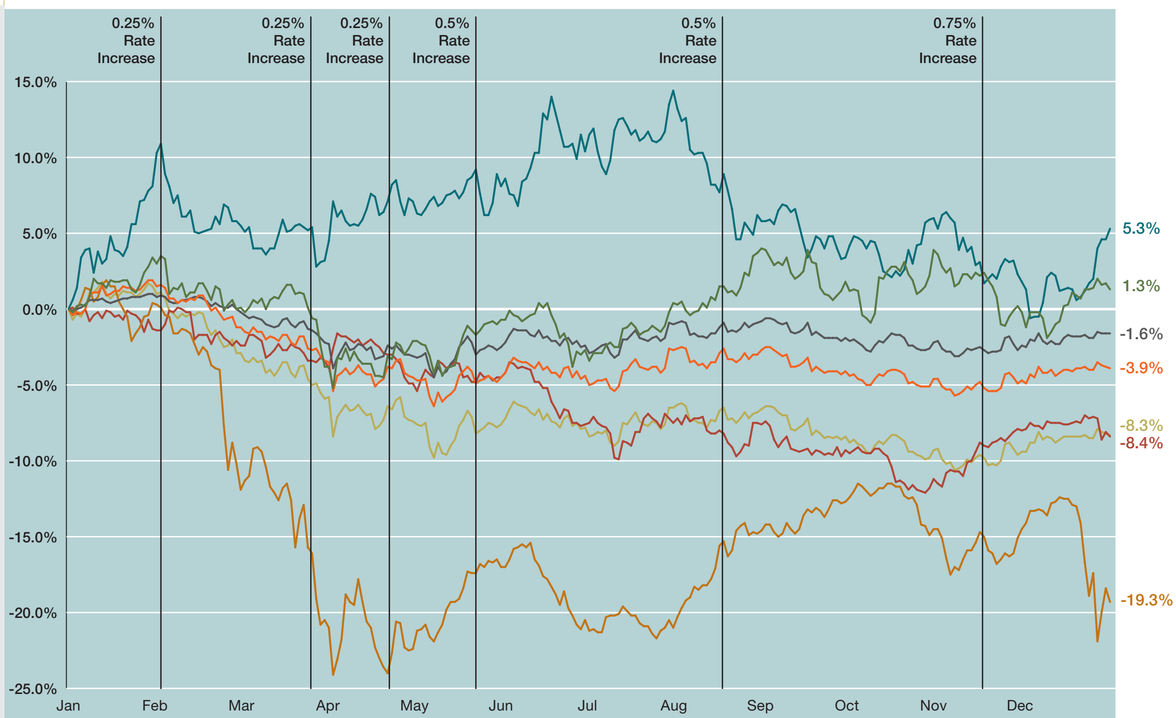
The driving force behind the sharp rise in interest rates in 1994 was Fed Chairman Alan Greenspan increasing the Fed Funds Rate from 3.0% at the start of the year to 5.5% by the end of the year in a series of six rate hikes. After maintaining a 3% Fed Funds rate for all of 1993, the Fed unexpectedly announced a 25 basis point rate increase in February 1994. What followed were five more rate hikes, sending Treasury yields soaring and bond markets down sharply. Notably, U.S. Treasuries (proxied by the 10-year Treasury note) were down more than 8% for the year while the U.S. dollar experienced a similar decline against a broad basket of currencies. Emerging market debt (in USD terms) also sold-off meaningfully as the unexpected rate hikes in the U.S. combined with the Mexican Tequila Crisis sent the hard currency index down more than 19%. Chart 3 on the next page shows the performance of various asset classes during this time period.

While a tightening of the magnitude experienced in 1994 is not imminent today, over some period of time it is likely that the Fed will need to bring the Fed Funds Rate back to a "normal" level. To the extent that interest rates rise in a similar fashion following a rate increase by the Fed, investors should expect dismal performance in fixed income markets. Other financial markets might suffer as rates start to rise for technical and fundamental reasons. First, investors might begin selling riskier assets when they view the yields on high quality bonds to be sufficient to meet their investment objectives. Investors might also become concerned about the fundamental pressure higher rates will put on borrowers to service their debt. In our view, the transition from easy monetary policy to higher rates will put pressure on a variety of fixed income sectors as investors adjust to higher interest rates.

Chart 3:
1994 Asset Class Performance & Fed Rate Hikes

Legend:
Commodities
U.S. Equity
MBS
U.S. Corporates
U.S. Treasuries
U.S. Dollar
EMD (U.S. Dollar)

Sources: Bloomberg; Rocaton



How should fixed income investors respond?

Despite the unexpected announcement, the Fed will eventually need to step back from its extremely accommodative monetary policy. As already mentioned, interest rates continue to be volatile and although it is beyond the scope of this paper, there are fundamental reasons to believe that a long-term rise in interest rates is on the horizon. With markets at what appears to be an inflection point, fixed income investors of all types (i.e. total return, liability driven, taxable) should consider how to best position their portfolios.

Total return oriented investors should continue to consider unconstrained or more opportunistic bond strategies that have greater sector and/or duration flexibility alongside of or in place of the more common benchmark-aware strategies (such as those tracking the Barclays Aggregate). Additionally, total return investors may want to consider adding more interest rate resistant strategies such as floating rate bank loans. These strategies have held up well through the recent rise in interest rates and may continue to perform well in the event of further interest rate rises. For those total return investors willing to sacrifice liquidity, attractive strategies exist which have the potential to deliver higher returns than traditional investment-grade fixed income. Note, however, that bargains in the investment-grade fixed income markets are hard to find these days with Treasury yields well below normal levels and corporate bond spreads close to normal levels. For total return taxable investors, municipals still appear to offer value. High quality municipals are offering higher yields relative to similar quality and duration corporate bonds, while also offering tax benefits.

For liability-driven investors the decision to add long duration fixed income assets in a rising rate environment can be difficult. Faced with this decision as funding levels are improving, plan sponsors should think of de-risking as two very distinct decisions: 1) determining the appropriate split between risk assets and hedging assets and 2) determining the appropriate hedge portfolio strategy including term structure, sector allocation, credit quality and degree of active management. Plan sponsors can reduce risk meaningfully simply by selling equities in favor of high quality bonds, which may or may not consist of long duration bonds. For those plan sponsors who have established glide paths, now is a good time to review those plans to ensure they are consistent with objectives and will respond to evolving market conditions appropriately.

Timing interest rates always has and likely will continue to be a difficult, if not impossible, task. Certainly the recent rise in rates, and the associated volatility, is notable, but, as with previous increases in interest rates, it may only be a blip on the radar. Regardless of the outcome, it is our view that investors should reexamine their current fixed income portfolios and plans given recent developments.