New Albany
Investment Management

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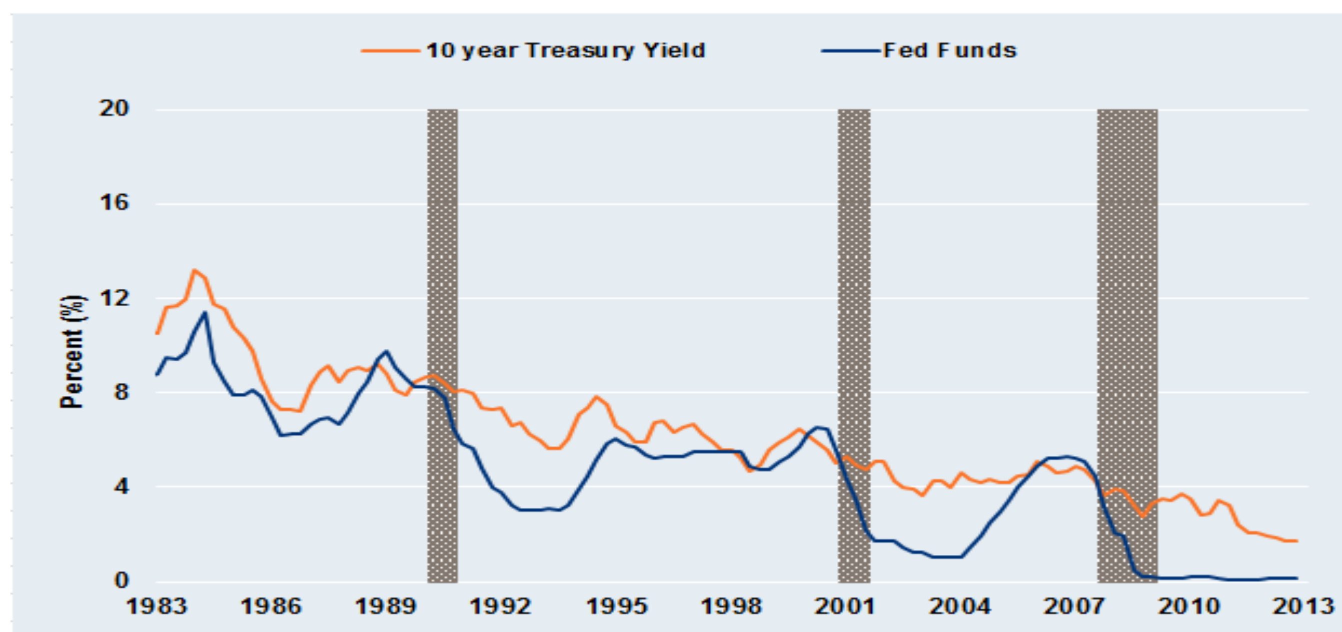
Market Insight: The Path to Higher Rates

Global markets have been struggling the last month over when and how fast the Federal Reserve will remove its stimulus program and in turn allow interest rates to rise. Bond markets had already begun anticipating a change in Fed policy, and Wednesday, it was confirmed by an announcement from Chairman Ben Bernanke. In response, US Treasury 10yr & 30yr rates have risen over 70bpts (0.7%) since early May causing bond prices to fall dramatically. Now, year-to-date returns for bonds is -1.7% to -6.0%, depending on the sector. The once sure safe haven for conservative investors has quickly become a minefield difficult but not impossible to navigate. Understanding and anticipating the potential path the Fed takes will be key.

The End of the Bond Bull: Since the peak in rates in the early 1980's the Bond market has had a great bull run. (See blue line on the chart below showing the yield on 10yr US Treasury falling from 7.8% in 1983 to 1.75% in 2013.)



Up until 2007, falling rates (rising prices) were a result of improvement in inflation and real productivity. But, since 2008, rates have fallen <u>only</u> because of the unprecedented action by the Fed of implementing quantitative easing (QE) or printing money to buy bonds. Since QE began, the bond market has been captive to the pace and magnitude of the Fed's bond buying program with the result being record low rates. Now, with the Fed announcing the coming end of QE, it is indirectly announcing the end of the great Bond Bull.

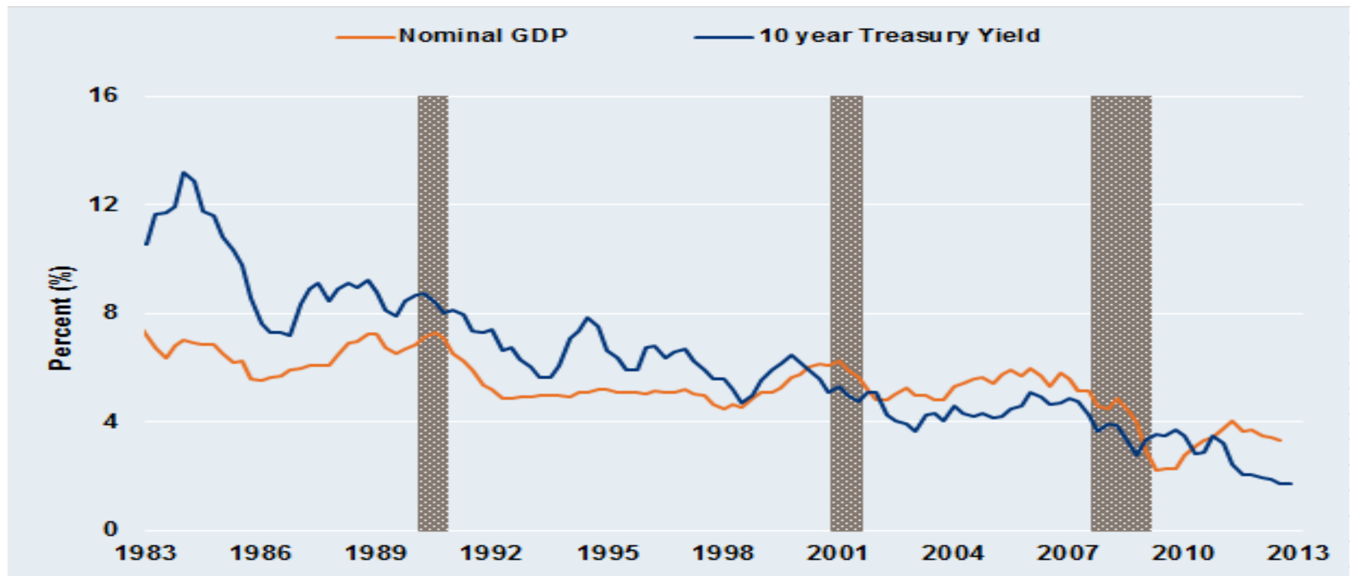
As QE is unwound, rates inevitably will rise presenting a headwind for all markets (stocks included) and the economy. It will cause greater volatility, making for a more challenging investment environment. Rising rates will likely be in three stages, impacting different parts of the yield curve.

- **Rising long term rates from tapering bond purchases**
- **Raising short term rates**
- **Raising long term rates thru selling long term bonds**

Stage One: Tapering the Fed's bond-buying program. The Fed's current policy involves buying $85 billion per month in Treasury and agency mortgage-backed securities. However, that is all about to change as the Fed announcement on Wednesday stated: *"the central bank expects to slow the pace of its bond purchases later this year and bring them to a halt around mid-2014*." Specifically, once the unemployment rate drops to 7% (currently at 7.6%), the Fed bond-buying program is finished***.*** Although buying fewer bonds isn't the same as actually tightening monetary policy, it's a less easy policy. So, just by *signaling* a shift in policy, the bond and stock markets have reacted strongly, pushing all asset prices lower.

How high could long term rates rise? Historically, there has been a relationship between year-over-year growth in nominal GDP and 10-year Treasury yields. Since 2000, excluding recession time periods, 10-year Treasury yields have averaged about 70 basis points less than nominal GDP growth. (See chart below) With GDP currently at 2.6%, this relationship implies that 10-year Treasury yields could rise further from the current level of 2.25% toward the 3% to 3.5% region.

Relationship of Nominal GDP to 10yr Treasury Yield (Gray denotes recession periods)



At the same time, short-term interest rates are likely to remain anchored near zero, causing the yield curve to steepen with long-term rates rising relative to short-term interest rates. This action will pressure long-term bond prices lower and mortgage rates higher.

Stage Two: Tightening by raising short-term rates. The Fed announcement indicated unemployment must be at or below 6.5% before they would begin raising short-term rates. In addition, stronger economic growth and higher inflation will be prerequisites for the Fed to move. Given both are currently well below the Fed's targets of 3.5% and 2% respectively, this stage probably will not begin until sometime in 2015. But, once the Fed begins to raise interest rates, the pace of increase in short-term rates will depend on how quickly the economy is growing and inflation. Assuming a gradual increase in both, it could take a few years for the Fed to bring short-term interest rates up to its "longer run" target of 4%, which based on the Fed's projections appears to be 2016 and beyond. Higher short-term rates will be a welcome relief for conservative investors that buy short-term bonds and CD's.

Stage Three: Tightening by selling long-term bonds from its portfolio. The Fed has purchased over $3.3 trillion bonds since 2010, taking 'supply' from the market and artificially pushing prices higher, rates lower. Re-distributing these bonds back into the market will pressure all asset prices, not just bonds. This stage will present a major headwind to the economy, and will only be put into action if and when the economy or inflation is overheating.

How high could rates go? Using history as a guide, if the Fed reaches its 4% fed funds target in 2016 or beyond, the 10-year Treasury yield could move up to 5.0% or higher. (See previous chart on page #1 of Fed Funds Rate and 10yr US Treasury).

Investment Implications:

The bond market has demonstrated that it is sensitive to any hints in a shift in Fed policy. While it may be a long road to a 5% yield on 10-year Treasuries, a move up to even 3.0% to 4.0% over the next few years will have a significant negative impact on the value of bonds and an investor's portfolio. The best course in a choppy rising rate environment is to proactively manage to Fed policy changes, being flexible in asset class selection and nimble in maturity exposure.

Portfolio Strategy: In anticipation of these policy changes, NAIM has proactively adjusted risk over the first and second quarter. Interest rate exposure to bonds was reduced through underweighting bonds and shortening the duration of the portfolio. Specifically, corporate bond exposure declined, while exposure to mid-cap equities increased. More recently, fixed rate investments were sold and replaced with floating rate bonds. Going forward, each stage will require a different tack but active management will provide solid returns.

As always please contact me with any questions or concerns.

Enjoy this beautiful weather!
Kind Regards,
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