LMCG INVESTMENTS

UNFILTERED

EDITION 10 | SEPTEMBER 2017

MONTHLY INVESTMENT COMMENTARY FROM LMCG

Bond Market Angst – REDUX

We thought it was an appropriate time to devote an edition of Unfiltered to Fixed Income. As we began our research, I remembered that we had written a piece, *Bond Market Angst*, in March of 2013. As I re-read it, I was struck by how many of the themes we talked about then remain relevant to today's environment. We have updated the commentary and charts to reflect today's bond market and present our current thinking. – *Matt Guleserian, CFA, Director of Fixed Income*

Thirty-six years ago in September 1981, the yield on the 10-year US Government Bond reached its 100-year peak of 15.8%. Rates have been declining ever since. Today, the 10-year Treasury rate is at 2.2%, which is just about 90 bps higher than its 100-year low. Although rates can stay low for very long periods of time, historically the trend has eventually reversed. Increasingly, clients are asking us for our views on the bond market and interest rates. In this edition of Unfiltered, we will look back on history to examine the risks in owning bonds, review our current outlook for interest rates, and explain how we are navigating through and investing in the bond market today.

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Lessons Learned

The probability of significantly higher interest rates in the near term is low, but they may begin rising meaningfully once the US economic recovery gathers steam. When that time comes, given today's historically low levels, a large jump in rates could lead to significant losses across the bond market. It is said that the markets do not repeat, but they do often rhyme. An analysis of past interest rate cycles provides us with valuable information that can help us navigate the next cycle:

- **The Absolute Level of Rates Matters:** Bonds are subject to additional interest rate risk when rates are low. Logic would say that faster increases in rates result in worse returns, but that is not the case. Rates rose faster and higher during the 1977-1981 period, but the drawdown was greater during the long and slow increase in rates during the 1954-1963 period because the starting point was lower.
- **Rate Moves Have Tended To Be Fast and Furious:** Since 1986, interest rates have steadily moved lower, vacillating within a 260 bps range. During the six episodes when interest rates approached the lower end of the channel, interest rates rose on average 136 bps in the following twelve months. See the chart below.

Source: Bloomberg

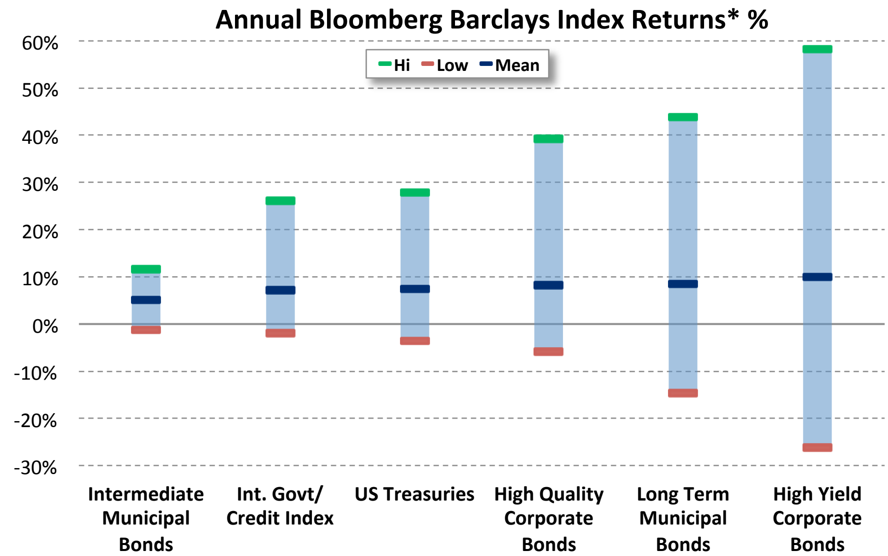
- **Investor Expectations Play a Role:** The key catalysts pushing rates higher during each of the rising rate episodes since 1986 have included: 1) expectations of a stronger economy, 2) concerns of rising inflation, 3) a widening belief that the Fed has finished easing, and 4) worsening federal budget deficits. While these factors are still relevant today and could push rates higher, the advent of Quantitative Easing (QE) since the financial crisis in 2008 has altered the effects that the Federal Reserve has on interest rates. The Federal Reserve's QE stimulus programs that were first introduced in 2009 brightened the outlook for growth and inflation and caused interest rates to rise. However, following the end of each QE campaign, rates moved lower (see chart below). Many investors attributed this to the still-sluggish underlying economy. Subsequent QE programs revealed a diminishing stimulus effect on the economy.

Source: Bloomberg

- **A Bad Treasury Market Does Not Mean a Bad Bond Market:** The level of Treasury rates alone is not sufficient to explain the movements in all fixed income asset classes. What may be bearish for Treasuries may be bullish for credit spreads; stronger economic growth can fuel improved credit quality and tighter credit spreads.

Two factors typically drive how volatile a bond will be: Duration and Credit Rating.

History offers important lessons, most notably that returns for high quality short-to-intermediate duration bonds have been remarkably stable. The past 40 years captures periods of both rising and falling interest rates, as well as various events that caused unusually high volatility in the capital markets (e.g., the Asian currency crisis (1997), Long Term Capital Management and the Russian default (1998), the Technology Bubble (2000), the Iraq War (2003), the Financial Crisis (2008), and the European Debt Crisis (2011)). The chart below shows that the greater the interest rate risk (as measured by duration) and credit risk taken, the more volatile were the returns. Despite periods of rising rates and unusually high volatility, the Bloomberg Barclays Intermediate Government/Credit Index and the Bloomberg Barclays 5-year Municipal Bond Indexes recorded only two negative calendar year returns since the inception of the indexes. In 1994, the Intermediate Government/Credit Index and the 5-year Municipal Index returned -1.9% and -1.3%, respectively. And they returned -0.9% and -0.3% in 2013 and 2016, respectively.



* Index Inception for Intermediate Government/Credit Index, US Treasuries Index and High Quality Corporate Bond Index is 1974. Index Inception for Intermediate Municipal Index, Long Term Municipal Index and High Yield Index is 1989, 1981, and 1984, respectively.

Source: Bloomberg Barclays Indexes

Don't Panic

Investors are right to be nervous. Interest rates now appear to be moving higher off their historical lows set in 2016 as the US economy continues to perform well and the stock market keeps hitting new highs. The growing consensus on Wall Street that bonds are overvalued is also rattling some investors. We agree that bond prices are high and the risks are growing, but we caution investors that it is nearly impossible to accurately predict where rates are headed. Forecasting interest rates is proven wrong more often than not.

Since the financial crisis in 2008, we have mostly maintained a benchmark neutral duration position in our client's fixed income portfolios. There have been periods when we tactically moved to a long or short duration position, but those periods have been short-lived. We've been confident that the concerted effort by the global central banks to hold interest rates down to stimulate growth would be mostly successful; rates have remained low, but so has economic growth, which has rebounded more slowly and less than during previous economic recoveries.

LMCG's Current Positioning: We are currently maintaining a neutral duration position in our client portfolios but are likely to shift to a shorter duration position if inflation data continue to strengthen. This tactical shift is also likely to be temporary as we do not see economic growth or inflation moving significantly higher in 2018, thus keeping a lid on interest rates. We point to several factors that support our current view:

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- **Rates Tend to Follow Growth:** The US suffers from the hangover effects of exploding debt and budget deficits. As a result, US GDP growth will likely remain below average, at only about 2-3% per annum. The historical correlation between rates and nominal GDP growth is high; thus, rates will likely remain low until more robust growth returns.
- **An Inflation Scare Is Unlikely:** Higher inflation often accompanies a GDP growth surprise. But that scenario appears less likely as there continues to be significant slack in the US economy. Current PCE inflation, which is the Fed's preferred measure, is running at just 1.7%, and has only approached the Fed's 2% target once briefly in 2011. Inflation expectations also remain well-anchored.
- **Economic Growth Remains Mediocre:** The difference between soft and hard economic data has widened significantly in 2017, but will likely converge in coming months. (Soft economic data is

comprised of surveys and confidence measures and have shown considerable strength in the US economy since the US election. Hard economic data is comprised of actual statistics released by the US Census Bureau and have shown softness in the US economy.) History has shown that soft economic data converges to the hard data more often than the other way around.

- **Credit Spreads Remain Tight:** Weak or widening credit spreads are typically an early indicator of an impending US recession or growth slowdown. Current spreads remain near historically tight levels.
- **Monetary Policy – The Fed and the Markets Are In Sync:** While the Federal Open Market Committee has indicated that they will start to shrink its balance sheet in October, they will take a very gradual approach as to not create too much upward pressure on rates. If prior episodes where QE ended are any guide, rates could move lower if investor confidence in the economy becomes shaken. Additionally, central bank policies outside of the US continue to repress global sovereign yields and push investors into high yielding US Treasury bonds, thus limiting a rise in US interest rates.
- **Fund Flows Are Still Supportive of Bonds:** According to the Investment Company Institute, flows into bond funds and ETFs continue to outpace that of equity funds and ETFs. Year-to-date through July 2017, bond and equity funds and ETFs recorded approximately $235B and $143B on inflows, respectively. In fact, the pace of inflows into bonds accelerated in September.

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Parting Comments

The primary reasons to include bonds in a portfolio, aside from generating a steady flow of income, are to preserve capital and to reduce volatility of other asset classes such as stocks; this strategy has been borne out by long-term historical returns for high quality intermediate duration bonds. Total return is important, but is typically a secondary consideration when allocating to bonds.

Losses may occur in the bond market, especially for longer duration and lower quality bonds. But a broadly diversified portfolio of short-to-intermediate high quality bonds has produced only minimal losses very rarely and never for any 2-year rolling period. Even in a rising interest rate environment, the risk/return profile of bonds remains attractive when considering the income component of bonds; coupon income flows can be reinvested at higher prevailing rates that can offset much of the negative price movements.

We recommend that fixed income investors remain fully invested and/or continue to invest in the fixed income asset class. We believe that it is virtually impossible to time the market or to forcast interest rates consistently. In addition, the current valuation challenges present in the equity markets suggests it may be a good time for a volatility offset. A professional bond manager can utilize several tactical strategies to enhance bond returns and mitigate risk for his or her clients, including: 1) adjusting the average duration of the portfolio to allay or amplify interest rate risk; 2) diversifying across various fixed income sectors to exploit different sources of return; 3) including different bond structures such as inflation-protected or floating rates to protect from inflation or rising rates; or 4) purchasing premium bonds to generate higher cash flows sooner that can be reinvested at higher rates. In our clients' bond portfolios, we have implemented all of these strategies at various times, as well as others, to enhance performance and protect their assets.

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