FSA INVESTMENT GROUP

Quarterly Market Commentary
May 2018

Will Lower for Longer Last?

"While past performance does not equate to future performance, examining historical periods that have the same characteristics as today can be a useful guideline for future expectations … bonds are faced with some serious headwinds, and investors should expect to earn below average returns going forward … investors must balance short-term safety with the possibility of below average returns going forward and adjust their asset allocation accordingly."

The highlighted passage was from Highland's white paper, The Future of the U.S. Bond Market, written in 2011. This paper shaped Highland's investment theme of lower yields for longer, which described the post-crisis cycle of interest rates and economic growth. This outlook has persisted for the last seven years, as unprecedented monetary policy has driven rates to all-time lows across the globe. However, we are approaching a point at which central banks will not be as accommodative and will begin to move away from crisis-era monetary policy. The Federal Reserve (Fed) took the first step when it raised interest rates in December 2015. Since then, its voting members have raised the target rate five more times. The Fed has continued to move rates higher even though its preferred inflation measure, Personal Consumption Expenditure (PCE), has not exceeded its 2% target since 2012.

The Fed's path to higher interest rates is well choreographed, while the frequency, or speed, of rate hikes is the unknown. Although yields remain low by historical standards, investors are becoming increasingly worried that bond yields are going to normalize and could revert to pre-2008 levels, which would be damaging to fixed-income portfolios.

Looking back to 2011, we heard these same concerns from investors. That led us to analyze the returns and characteristics of bond markets going back to the 1800s. Our study demonstrated that the post-1980 yield environment was the aberration (see Figure 1). The average yield on the 10-year U.S. Treasury since 1800 was 4.7%. Looking at historical

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FSA Investment Group does this with the highest levels of trust, integrity and respect while always collaborating using a team approach. We are dedicated to professionally supporting, educating, and providing informed direction to each and every client.

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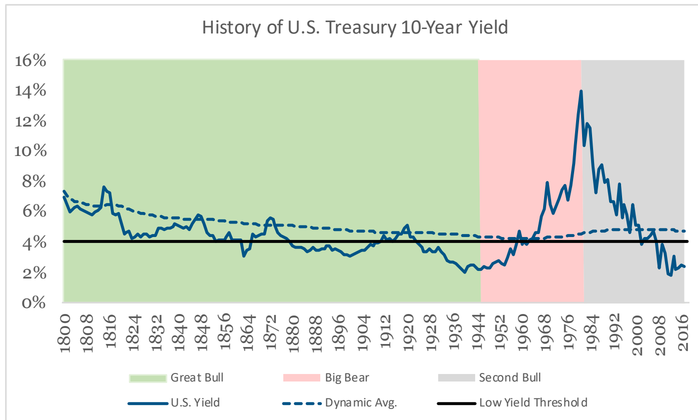
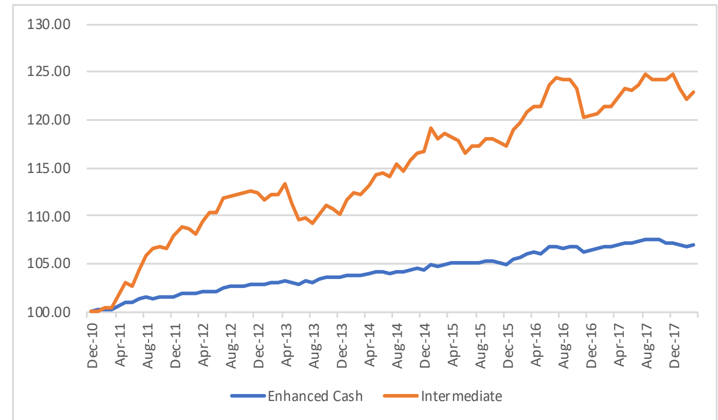
Figure 1



Sources: FactSet; U.S. Treasury; Homer and Sylla; Wilson and Jones; Shiller; Highland Associates

Figure 2



Source: FactSet; Highland Associates; Enhanced Index = Bloomberg Barclays U.S. Aggregate (1-3 Y); Intermediate = Bloomberg Barclays U.S. Aggregate; Returns Indexed to 100 starting at 12/31/2010

interest rate cycles, we concluded that periods when the yield was below 4.0% constituted a low-yield environment. Our investigation revealed that low-yield eras in the aftermath of a financial crisis have historically been long in the tooth (greater than 20 years).

Our efforts turned to an evaluation of short-, intermediate-, and long-duration bond returns over three-, five-, and ten-year time frames. The study demonstrated that intermediate bonds outperform short- duration bonds and match long-duration bonds. Consequently, Highland maintained intermediate duration in bond portfolios, which benefited client portfolios (see Figure 2). The analysis further showed that returns in general are muted for bonds in low-yield environments. Accordingly, it was best to position portfolios to be underweight fixed income, which has been our recommendation the last seven years. Both of these positioning calls aided client portfolios, as fixed income generated lower than normal returns, with intermediate cumulatively outperforming short duration by 16%.

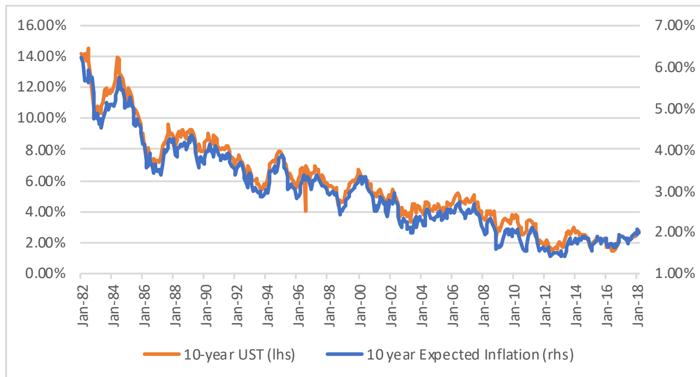
When we completed our analysis in 2011, the 10-year U.S. Treasury was yielding 3.3%, while today the 10-year is yielding just under 3.0%. Additionally, the Fed's expected terminal rate for the Fed Funds was 4.3%, whereas today it is less than 3.0%. Despite central banks globally purchasing more than $12 trillion in assets, we remain firmly in a low-yield environment globally.

We may have reached a point in the cycle where the path of least resistance for bond yields is higher. After the shock from the U.K.'s decision to leave the European Union, bond yields bottomed in July 2016 and have been on an upward trend since then. The U.S. 10-year yield has risen over 120 basis points since its low. The Fed has moved from a data-dependent stance to a data-defiant stance. As long as its voting members continue to see economic growth, business confidence, and low stress in the credit markets, it will push rates higher. The Fed is mindful of falling behind the curve with inflation as the benefits from tax reform, a higher budget deficit, and increased tariff talk could lead to an uptick in prices. Another factor that could sway the Fed's decision is the market's reaction to the European Central Bank ending its asset purchase program, which is expected by the end of this year.

As we approach 2018 and beyond, the questions front

and center on investors' minds are these: Will this lower-for-longer stance continue, or have we entered a new environment that warrants a change in positioning? While inflation expectations have risen, they remain near historic lows (see Figure 3). In order to exit the current low-yield environment, we would first need to see a substantial increase in inflation expectations. Conversely, if inflation expectations were to rise too high, then this would give the Fed fuel to be more aggressive in its rate hiking. Historically, when the Fed quickens its pace of rate hikes, the slope of the yield curve has flattened as long bonds remain anchored. This would favor maintaining intermediate duration.

Figure 3



Sources: FactSet; Cleveland Federal Reserve; Highland Associates

Moreover, the Fed has a poor track record when it comes to finding an optimal tempo for rising interest rates. History shows that the Fed typically overshoots its pace and eventually pushes the U.S. into a recession. According to Dave Rosenberg of Gluskin Sheff, of the 13 Fed hiking cycles since World War II, 10 of these landed in a recession.

It is interesting to note that we have never had the Fed raise interest rates this late in an economic expansion. In May of this year, this economic expansion will be the second longest on record, and if it continues into the summer of 2019, as forecast, then it will be the longest on record. Yet, if something derails the economy and a recession ensues, then bond yields would be expected to decline as investors begin to adopt a risk-off posture. The 10-year bond yield has declined an average of 160 basis points from the start of the recession to the low in the recession. While we would not expect that magnitude at these levels, we would presume bonds to rally due to investor flight to safety.

While there are still some significant unknowns on the economic front, we believe the lower-for-longer rate environment is shifting. So what does this mean for fixed-income portfolio positioning? Continuing with our assumption that we remain in a sub 4% yield environment, we analyzed how bonds of different durations performed in similar cycles. Since 1927, there have been 13 rising interest rate periods during low-yielding environments. On average, shorter-duration securities outperformed intermediate-duration securities by 0.74% during those periods. However, it's a very tight window to achieve these returns. If we look at these time periods with just a three-month lag, then intermediate bonds outperform short-duration bonds. In light of this precision, market timing plays a key role. We believe investors are better off not trying to time duration calls and instead focus on when to over- or underweight the asset class.

As part of our analysis, we looked at various rate scenarios and evaluated the expected return under different settings. This included shocking bonds under the following scenarios:

1. Utilizing current market-based futures for the analysis
2. Interest rate normalization to pre-2008 levels
3. Inversion of the yield curve
4. Rising interest rates and a steep curve
5. Rising interest rates and a flat curve

Although most investors have longer time horizons, these scenarios were analyzed over shorter periods of two, three, and four years (see Figures 4-6). In the two-year scenario, intermediates outperform short-duration bonds for three of the five scenarios. The two scenarios in which short-duration bonds outperform are the following:

- If interest rates normalize to pre-2008 levels, or
- We see rising rates and a steep curve setting.

The first scenario in which short duration bonds outperform seems unlikely based on the current environment and the Fed's track record since 2008. As for the second scenario, there is some disagreement among investors as to whether the yield curve will steepen or remain flat. History favors a flattening yield curve. The Fed's long-run estimate for its target rate is 2.9%. The current Fed Funds rate is 1.75%, which leaves five rate hikes from meeting its target. Using the past as a guide, the yield curve (e.g., 10 year – 2 year) at this point in the rate hiking cycle has historically been 50 basis points, on par with where we currently sit. However, history shows that as the Fed raises rates, the yield curve flattens until it eventually inverts. The steepening scenario is certainly possible, but at this point, we believe a flat yield curve is more likely.

When we look at the analysis over a three- and four-year time frame, we get a similar picture. In the normalization and rising rates and steep curve scenarios, short duration outperforms intermediate-duration bonds. However, the magnitude of the outperformance is lessened.

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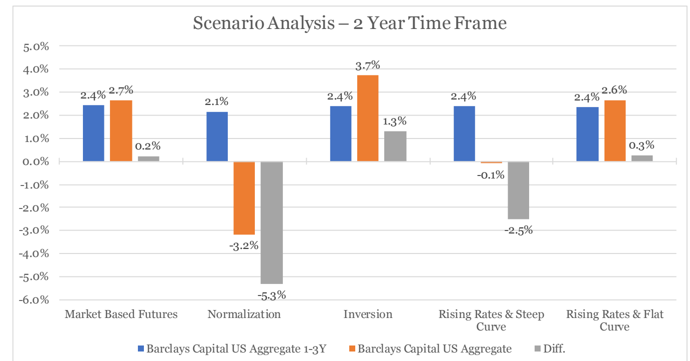
Figure 4



Sources for Figures 4-6: FactSet; Bloomberg Barclays; Highland Associates Enhanced Index = Bloomberg Barclays U.S. Aggregate (1-3 Y); Intermediate = Bloomberg Barclays U.S. Aggregate; Scenario 1: Compare using market-based futures; Scenario 2: Interest rates normalize to pre-2008 levels; Scenario 3: Utilize market-based futures for the short end and then invert the long end; Scenario 4: Utilize market-based futures for the short end and steepen the long end; Scenario 5: Utilize market-based futures for the short end and maintain a flat curve.

Figure 5

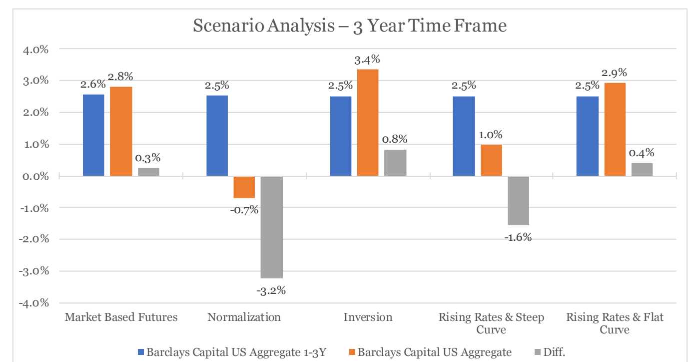
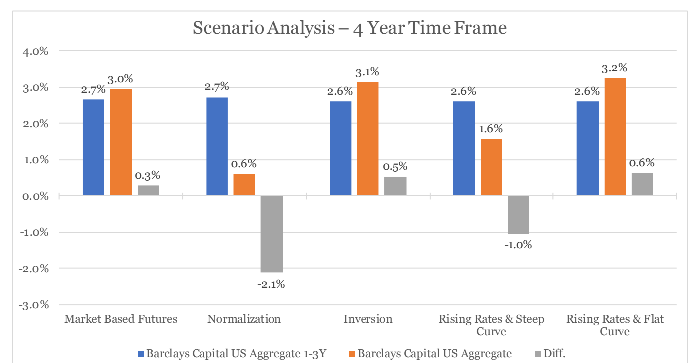


Figure 6



Viewpoint: Have the Facts Changed?

There is a famous quote attributed to influential economist John Maynard Keynes, who, when criticized for making contradictory remarks, stated, “When the facts change, I change my mind. What do you do, sir?” After looking at both history as a guide and different rate scenario environments, we see no immediate reason to change our positioning and continue to favor intermediate over short-duration bonds. If economic growth were to revert back to its 50-year average of 3.0% and yields moved above 4.0%, then this would drive us to revisit our positioning. Additionally, we recognize there is some uncertainty associated with a new Fed Chairman and future appointments to vacant spots. If there were a wholesale shift in the Fed’s policies, then this could also cause us to reconsider our stance.

Although we could see bond yields go higher, we do not foresee them rising over 4%, thus continuing in this low-yield environment.

We feel the outlook for bonds is poor no matter how you assess it. Either inflation rises, and central banks can’t control inflation, causing poor performance in bond portfolios, or we remain in a low-yield world, where returns after inflation (real returns) are subpar. Our belief is that we will remain in this sub 4% low-yield environment, which does not bode well for fixed-income returns. It is normal to see periods of rising rates in bonds during protracted bull markets. Although we could see bond yields go higher, we do not foresee them rising over 4%, thus continuing in this low-yield environment.

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PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

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