POSITIONING BOND PORTFOLIOS FOR FUTURE RATE HIKES

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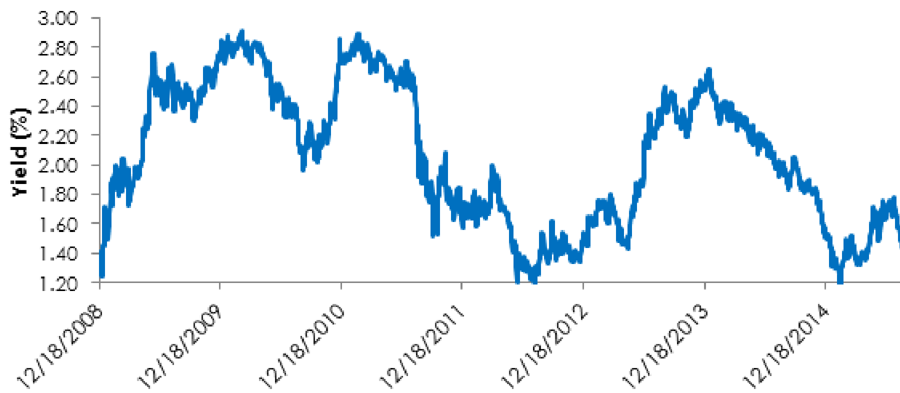
While swings in global asset prices have been unnerving to many investors, we remain focused on the largest potential story for global markets outside China: an inevitable shift in monetary policy by the Federal Reserve (Fed) in the coming months. While the Fed ultimately decided to hold off on hiking rates in September, we remain convinced that a rate hike is likely by the end of 2015. However, while some advisors may speak about rising rates casually, we believe it's important to review what rates may be most impacted when the Fed finally does raise rates. **All Interest Rates Are Not Created Equal** The two most difficult questions about preparing for a Fed rate hike have regarded timing and targeting which rates may be poised to rise the most. When the Fed hikes rates, this shift in policy will have ripple effects across the short end of the yield curve as interest rates readjust. This is precisely what we saw over the last several weeks. Leading up to the September 17 Federal Open Market Committee (FOMC) meeting, rates on 2-Year U.S. Treasury notes rose by more than 24 basis points (bps) from their lows in mid-August.[1] On Thursday and Friday, these rates fell by 13 bps when the Fed delivered no change and "dovish" commentary. However, the ultimate impact on the longer end of the yield curve may be what matters most to many bond investors. In many ways, the impact of a change in Fed policy on the long end of the yield curve remains open for debate. **Long Bond Remains Low for Longer:** One analyst camp says that long-term rates needn't rise because falling commodity prices and slower global growth will keep inflation constrained. Therefore, with a major determinant of interest rates not necessarily changing with the Fed, rates can remain low. **End of Secular Bond Bull:** The other camp believes that any Fed change is an endorsement that the historically low period of inflation may have bottomed, and therefore increases in inflation may be just around the corner as the economy continues to expand. In our view, the risks of being wrong on inflation and longer-term interest rates far outweigh the "benefits" of being right. In the most recent sell-off in global equities, U.S. interest rates declined only modestly on this significant "risk-off" move—one sign there may be limited gains to be had from long positions in long bonds. In the days following the Fed's rate decision, the initial drop in yields had largely been unwound. This suggests to us that investors should question being market weight in duration risk. This conundrum is compounded as many have sought comparative safety in the short end of the yield curve—which also is at risk here. **Short End at Risk** As we mentioned previously (and seen in markets recently), the short end of the curve is the segment that will likely come under the most significant pressure once the Fed lifts rates. Crowded positioning, uncertain timing and investor complacency could result in an unfortunate combination. One solution for these difficulties may be to maintain similar exposure to a bond portfolio but hedge interest rate sensitivity to zero. **The Shape of the Yield Curve Matters: Steepening vs. Flattening** In a separate but related issue, most fixed income textbooks talk about rising rates in academic terms, often relying on parallel shifts in the yield curve to illustrate the concept. Put another way, this assumes that interest rates rise uniformly across all points of the curve. As we show below, this isn't always the case. **U.S. Treasury Curve: 2-Year vs. 10-Year**



Source: Bloomberg, as of 9/23/15. Past performance is not indicative of future results.

As the chart illustrates, comparing the 2-year yield against the 10-year yield of U.S. Treasuries gives investors an idea about the range of possibilities for the shape of the yield curve. Lower numbers imply flattening, whereas higher differentials imply a steepening trend. Yield curves are generally upward sloping—that is, rates are generally higher moving from 1-year maturity to longer maturity across the curve. This is primarily driven by changes in the perception of the timing of Fed rate hikes. However, market perception can and does change. From January 30, 2015, through June 10, 2015, interest rates in the U.S. rose across the curve, particularly at longer maturities. As rates at the long end rose more quickly than at the short end, this steepening in the yield curve resulted in strong performance for our suite of negative duration bond strategies. Ultimately, the relative level of interest rates will be determined by the outlook for the U.S. economy and investor supply versus demand. In our view, investors should consider hedging interest rate risk as opposed to simply moving it by moving into the shorter end of the yield curve. Based on their views about the future path of inflation, more opportunistic investors should consider negative duration strategies as one way to profit from a rise in long-term bond yields. These duration-hedged strategies will become especially important as the Fed discussions shift from focusing on the gradual pace of rate hikes to the eventual shrinking of the Fed's balance sheet —potentially in the latter half of 2016. Increasing bond supply in the market at the long end could see greater pressure for those rates to ultimately drift higher.

[1]Source: Bloomberg, as of 9/23/15.

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DEFINITIONS

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Rate Hike : refers to an increase in the policy rate set by a central bank. In the U.S., this generally refers to the Federal Funds Target Rate.

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Federal Open Market Committee (FOMC) : The branch of the Federal Reserve Board that determines the direction of monetary policy.

2-Year Treasury : a debt obligation of the U.S. government with an original maturity of two years.

Basis point : 1/100th of 1 percent.

Dovish : Description used when stimulation of economic growth is the primary concern in setting monetary policy decisions.

Inflation : Characterized by rising price levels.

Secular bond bull : a prolonged period generally characterized by lower interest rates.

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Hedge : Making an investment to reduce the risk of adverse price movements in an asset. Normally, a hedge consists of taking an offsetting position in a related security, such as a futures contract.

Steepen : an increase in the spread between short-term interest rates and longer-term rates.

Flatten : to effect a zero positio.

U.S. Treasury Bond : a debt security issued by the United States government.

Maturity : The amount of time until a loan is repai.

Balance sheet : refers to the cash and cash equivalents part of the Current Assets on a firms balance sheet and cash available for purchasing new position.