Investing in a Rising Rate Environment

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The prospect of rising rates has been hovering in the global economy for years now. But it seems that there is a realistic expectation that interest rates will actually rise soon, at least in the U.S. With this change in mind, *Pensions & Investments* brought together three well-respected fixed income managers to answer key investor questions, such as how to structure portfolios for what may be a turbulent time, and how to view the prospects for inflation and growth.

While all three managers agree that rates will rise in the U.S. sometime soon — a view shared by the bond markets — they are not all agreed on how investors should position themselves. Go to cash to have dry powder for market corrections? Give your manager more discretion to react to market dislocations? Stay away from U.S. Treasuries? Embrace the credit cycle? All these questions and more are answered in the discussion below.

P&I: ***What is your view on the prospect for rising rates?***

Chris Diaz: I think longer-term rates will rise, but rise gradually. So in the next 12 to 18 months, I would expect 10-year yields to increase, not by very much, but to between 2.5% to 2.75%. In the U.S., we'll see a flattening of the yield curve as the Federal Reserve Board begins to raise interest rates, so front-end yields will increase more than longer-term yields.

The reason I have such a benign outlook for longer-term yields is that I think that potential growth in the U.S. has fallen quite significantly due to low levels of productivity and slower population growth. And frankly, low levels of inflation should work to keep longer-term interest rates pretty low.

Dan Dektar: I generally agree with Chris, but would add a couple of points. We know that short-term rates are low and are destined to rise over time. It's hard to know exactly when, but they aren't going to rise significantly unless long-term inflation picks up. We have noticed that long-term inflation protection is underpriced. Investors are overpaying for deflation insurance. So when we break the curve down, parts of it look reasonable, such as long-term real rates. Part of the curve looks low, such as long-term inflation pricing.

Another issue that isn't well-understood is that the yield curve does project higher interest rates over time. You can lose money — even as rates are rising — by just sitting out of the market. That's because rates may rise, but not as fast as what's priced into the market. That's been the case for the last eight years. The 10-year yield has been at or below 2.5% at some point during each of the last eight years, even as there has been a general concern about rates going up. Investors that are constantly concerned about rising rates are going to miss out on opportunities to be in the market from both a duration and an alpha-generation perspective.

Rob Waldner: I don't think we have too much of a difference of opinion here among the three of us. What I would stress is that the terminal Fed funds rate is lower than it has been in the past, and as a result, the long end of the curve should remain relatively well-contained for exactly the reasons that Chris alluded to. Demographics and the lack of productivity mean that potential growth is lower. Lower potential growth begets lower long-term bond yields.

We're unlikely to see bond yields go up to levels that we saw a decade or two ago. That is well outside our expectation, though some professionals may be expecting that. Certainly some investors see that as a risk. We don't. On the other hand, we do think that the U.S. economy will continue to perform well and that the Fed will have to raise rates at the short end.

As we move away from a zero-interest-rate policy and the quantitative easing that we have had here in the U.S., we expect higher volatility in interest rates going forward. Specifically, we expect higher volatility at the short end, an area of the curve that has had relatively little volatility in the last five or six years.

P&I: ***Given that you all agree that there are rising rates coming into view, how should an investor be positioned at the asset allocation level?***

Rob Waldner: Our main message to investors is this: "Unless you really need to have a lot of Treasury duration

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> *~ Dan Dektar, Amundi Smith Breeden LLC*

in your portfolio, we think you should be seeking other opportunities." There are many fixed income opportunities away from traditional Treasury and agency assets.

I'm sure my colleagues will agree that there are opportunities in more actively managed fixed income sectors because we've seen tremendous growth globally and in the U.S. in terms of the options that are available. We can now build more diverse portfolios than we could in the past. And we can use active management to manage around some of the trends we mentioned.

We would point investors toward rethinking their fixed income allocations a bit to make sure that they are really taking into consideration all aspects of what is a broader fixed income asset class. When you're hiring a manager, hire one that can look across the landscape and generate fixed income solutions, rather than just fixed income portfolios. Because with the relatively low yields and low spreads in the market today, your cushion against volatility rising is lower. We propose that clients think about fixed income from a solutions, rather than just an asset class, perspective.

Dan Dektar: Interest rates affect the valuation of all assets: equities, commodities, fixed income, of course. There may be an idea that interest rates could go up and that would make equities a better place to be. In fact, equities have more duration than bonds. So equities would not be a safe haven from interest rates alone.

We separate the yield curve into a real-rate component and an inflation component. Low real yields have supported asset valuations in asset classes globally. So one implication would be that a pension fund or other institutional investor should have a higher weighting to cash today than in a normal real rate environment.

If asset values represent the sum of future values discounted at today's interest rate, to the extent that today's interest rate rises, it's going to result in a lower present value for any asset class. As central banks eliminate accommodation over time, we expect the real rate of interest to rise and lower the valuation of these asset classes. It's as if returns have been front-loaded for all asset classes, so future returns — given today's low rates — are expected to be lower.

As real rates normalize over time, you would expect all asset classes to depreciate relative to where they are today, and this process may be somewhat disorderly. You see it already: every time the Fed hints that they might raise rates or turn a bit hawkish, there are shudders in the bond markets, in the equity markets, and in the currency markets. So by having a higher cash weight today, an investor has dry powder to buy depreciating assets in a volatile market environment.

Chris Diaz: In a gradually rising rate environment, investors should not be afraid of fixed income. There is

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a significant cost, as Dan mentioned, to holding cash in a fairly steep yield curve environment. But places like investment-grade credit and high yield can absorb some of the increase in risk-free yields.

You can also look globally. There are different parts of the world that are in different phases of their monetary cycles. Europe is in the middle of quantitative easing and in an economic cycle that likely lags the U.S. by a few years. And there are areas where bonds are still, frankly, quite attractive and where we think that yields can actually decrease — that is, experience price appreciation.

Lastly, I would be cautious of either real assets, inflation-linked securities or anything that is correlated to commodity prices. The weakness we've seen in China and the excessive supply of crude oil around the world is likely to keep commodity prices low, which will keep inflation low as well.

P&I: ***Describe your attitude to risk at the moment and how that might change if rates were to rise substantially.***

Dan Dektar: Although none of us here believe that there will be a sharp upward move in rates, there is certainly popular concern about it. We all recognize that liquidity is somewhat constrained, for several reasons. Dealers have reduced capital allocated to sales and trading because of Dodd-Frank and other financial regulations. So counterparties just aren't around to absorb risk. The market, too, is moving as a big herd driven by just a couple of factors, including the stance of monetary policy. So although we expect rates to rise gradually, we do expect considerable bouts of volatility — or what in fixed income we call spread flares, as the market gets jumpy about economic, political or monetary policy developments. So we are maintaining cash.

We would recommend that plan sponsors do the same in order to take advantage of these bouts of volatility that we're going to have and perhaps the lack of liquidity as well. We think spreads are reasonable in many asset classes for where we are in the economic cycle, but expect spreads to widen during some of these bouts of volatility in the future.

Our risk stance reflects our anticipation of volatility. I think much of the world is very, very short term in perspective on performance, whether it's due to Value-at-Risk constraints or it's a hedge fund that is marked to market. They have to do stop-loss selling when the market goes against them. Recently, we've all seen the effect on the dollar and the German bond market. The aggressive behavior of these short-term investors creates opportunities for long-term investors like ourselves and our clients. We need to be prepared and also prepare our clients for a volatile environment going forward.

Rob Waldner: We think there are two important facts that will impact the volatility and behavior of markets going forward. One is that we're coming off a very long period of zero interest rates. Our sense is that many investors have built-up positions in recent years that may need to get unwound when short-rate volatility reappears. So we would anticipate that you would get volatility — spread flares, as they have already been called — as the short end of the yield curve rises. We do think volatility overall will increase.

Second, when we talk about rising rates, we're really talking about rising interest rates in the U.S. We don't anticipate rising rates elsewhere around the world to the same extent. As a matter of fact, we think the global economy is characterized by divergence. What that means is that even while the Fed is raising rates, the other major central banks will be continuing to ease, and that easing should be supportive of fixed income assets in those regions. The divergence between the U.S. Fed and other central banks is also going to be a major contributor to volatility. We think we're in a period of volatility going forward and that would counsel keeping risk in portfolios relatively low.

We don't think specifically about cash positions because, of course, cash at the current time yields you zero. But we would keep our positions cautious. That ties in to the advice that we are giving clients, which is that market movements could be sharper and faster, leading to quick changes in spreads, particularly in less liquid conditions.

In that environment, it is beneficial to have a professional manager who can help an investor to make those allocations to increase or decrease risk. It's harder to do that quickly in the traditional asset allocation framework. It's easier to do within the context of a portfolio where the manager has the ability to increase and decrease risk.

We are asking our clients to give us the broadest set of risk parameters that they can. That means we can keep their risk profile low now, but be prepared to add to the risk if we get a situation where opportunity is created due to rising rates of volatility.

Chris Diaz: I agree that portfolio strategies should be cautious for the exact reasons that Dan and Rob point out. We are entering a new paradigm where the Fed will be raising rates. That's going to be very different than the last few years of zero interest rates. Liquidity is challenged, so I would expect volatility to stay high.

I'll focus on some other areas of risk that we see. One area is market pricing for the expectations of the Fed funds rate. We see those expectations as benign currently, more benign than the information that we have received. And while it's certainly not in our base case, any evidence of inflation or wage pressures would result in a repricing of Fed expectations, and could cause tremendous volatility and put significant pressure on risk assets.

At a time when the Fed is raising rates, we think that there's significant risk that we could see from the emerging world. We've been talking for the last decade plus about the BRICs — Brazil, Russia, India and China. Brazil is in recession, as is Russia. China is growing at half — if that — of where it was pre-financial crisis. Potentially, we could see some significant defaults in the emerging world, Venezuela for one. These are potential systematic risks that managers and investors should be aware of.

P&I: ***What is the main risk that you think investors are most worried about in relation to rising rates?***

Dan Dektar: One subject that's gotten a lot of publicity

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that ties in with volatility is liquidity risk. And there are different types of volatility — economic volatility and price volatility. We know that the stock market is a lot more volatile than the actual economy. Psychology causes prices to fluctuate more than economic activity and the same is true in the bond market.

We haven't had a lot of economic volatility, but as Chris pointed out earlier, we've had a long period of low interest rates and a buildup in positions that have worked pretty well for investors. However, they may be ready to sell out at the first sign of trouble — either the Fed raising rates or prices going down or whatever. So we do expect considerable price volatility ahead.

We don't have the buildup in leverage that we had in 2007 and 2008, so we aren't really concerned about liquidity issues in developed markets turning into solvency issues like we did then. But there has been this buildup of overweight positions among some investors — and they are ready to get out. That will create price volatility that we want to be able to take advantage of.

There is a buildup in leverage in emerging markets and certain corporate sectors that may cause more of a solvency issue. Plan sponsors need to be ready for this volatility and what it's going to look like. And they need to be prepared to take advantage of it either by being very quick and flexible in their asset allocation or by delegating flexibility to managers. Some of these opportunities may come up for a day or two, and then they will be gone. If you are waiting for a policy or committee meeting to make a decision, you will have missed it.

Rob Waldner: I think it's worth repeating to clients what we mean by expecting more volatility. Fundamentally, the increased volatility we expect to see is due to less certainty around economic growth and inflation, and less certainty around policymaking going forward.

Those uncertainties are going to continue as we get even more divergence between the U.S. and other global economies. We expect to see more situations where countries will have difficulty implementing economic policies, as we are seeing in China currently.

Volatility and its implications are very important things for clients to understand. I agree 100% with the point that it is much easier to take advantage of volatility when you can integrate it into one portfolio, than when you try to allocate over longer cycles.

Asset allocation can be useful for allocating through an economic cycle. But at this point, with divergent economic cycles globally resulting in increased volatility, asset allocation is not that effective a tool for navigating this environment. More integrated, active management is.

Chris Diaz: Investors should be prepared for more volatility. It is undeniable the influence that global central banks have had on fixed income markets — and all markets in general. The world's largest central bank is in the process of reversing policy. That's happening in a fixed income market that has considerably less liquidity than it did pre-financial crisis. So fixed income investors

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should be prepared for more volatility. This will create opportunities for investors, but also additional anxiety. We are entering a different regime.

Dan Dektar: In high-grade fixed income, if an investor is selling because they have seen a poor short-term return or their Value-at-Risk calculation looks bad, they may be missing the long-term opportunity when volatility increases. To take advantage properly, you need to have a time horizon that's longer than the average market participant. So one thing to consider when you are preparing for this coming volatility is your time horizon.

Another issue — more of a markets issue than an investment issue — is making sure that you are invested in vehicles with the right liability structure. What I mean is invested in vehicles that can withstand the volatility. I wouldn't want to be in an emerging-markets or a high-yield fund with an investor group that's going to pull out at the first sign of trouble, because then I'm not going to be able to achieve my investment objective.

So investors should make sure that they are in the vehicle that's most appropriate for the asset class. In general, it makes separate accounts more attractive than funds. It makes smart institutional funds a better place to be than investing alongside more flighty retail investors.

P&I: ***What asset classes or sub-asset classes will become more attractive in a rising rate environment?***

Rob Waldner: Dan just mentioned high yield, but we like bank loans. Bank loans are a sub-investment-grade asset that is higher in the capital structure than high yield, has a floating rate and therefore is attractive. With our view that the short end of the yield curve will probably rise first, bank loans make sense to us. Bank loans are protected from any moves at the long end of the yield curve, though we're not concerned about that.

Although we expect to see a pickup in volatility, high yield should do well through a rate-hike cycle. That's because historically, high yield performs well when the Fed is raising rates because of economic strength, but not so aggressively as to create a recession. We expect that when the Fed does raise rates, it will be doing so on the back of decent growth. A steady rate increase accompanied by good economic growth is an environment that is very positive for the fundamentals of credit — decent corporate performance, very little pickup in defaults.

We're not so positive on government bonds because you're actually locking in negative real yields in many government bonds currently. Investors will get back less in the future than they are investing now, in terms of spending power adjusted for inflation, so that would not be a place to be.

Chris Diaz: We like global bonds as well, mainly European bonds because the European Central Bank is involved in QE. We've seen that show before in the U.S. and it played out well. In general, fixed income should be fairly well-supported in Europe. We also like credit in Europe, but we are more partial to peripheral European bonds, particularly if we get the Greece situation behind us. That would be countries like Spain, Portugal and Italy.

Second on our list would be high-yield credit in general. But I would add that we are entering a cycle where the beta trade is over. Just taking money and throwing it at the credit sector, expecting to win, isn't going to work. Those days are over. You're going to have to do your homework, as security selection is going to become very important in that space.

Floating-rate assets make sense in the U.S. where the Fed could be raising rates. I would reiterate that at current pricing — and specifically in the U.S. — inflation-protected securities do not appear very attractive. That is, one, a function of current pricing and two, our view that commodity prices will be lower in the future.

Dan Dektar: When I talk to plan sponsors about what asset classes are attractive, the big question is duration. Every one of these asset classes has a duration component. I think duration should be managed at the fund level. Each of these asset classes can be measured as to their sensitivity to interest rates. And duration can be managed independently.

For example, if you want exposure to corporate credit, there are many opportunities, but you don't need to be tied to the corporate index, which has a duration of six or seven years at this point. You can invest in corporate credit with a lower duration. The same goes for loans. If you like loans and need more duration, you can add duration to your overall fund. So first, separate the duration component from the essential risk of the underlying asset class.

We're very positive on loans that are backed by automobiles, credit cards, houses — what is sometimes called securitized credit. It's an area where collateral values will be improving and the credit quality of the asset will naturally be getting better if rates are moving higher because of rising inflation.

P&I: ***What are your thoughts on the prospects for real assets and commodities in a rising rate environment?***

Chris Diaz: The marginal price setter of commodity prices is China. Yet again, prospective growth is being revised lower by market participants. It's already at a rate that is significantly below where it has been in years past. That really affects all commodity prices.

When we look at the most important of commodities — crude oil — prices are likely to remain low. Global growth is probably still below potential. In addition, there is a significant oversupply of crude oil coming onto the market relative to demand. We think that will continue to place downward pressure on crude oil prices and the weakness in the Chinese economy will keep a cap on all commodities.

Dan Dektar: It's not a case of whether we like certain asset classes or don't like them. We see them in a two-by-two matrix, where one axis is inflation and the other is growth. There are asset classes that do well in each one of those quadrants. Commodities do especially well in a high-growth, high-inflation environment and poorly in a low-growth one. The only asset that does well in a low-growth, high-inflation environment would be TIPS. Real assets in general will perform better if growth is better, as would equities.

So if you start by asking, "How can I do well in each of these quadrants?" I think you want to have some inflation-linked assets, not hedged, necessarily. For the high-growth, high-inflation quadrant, you want commodities and equities. And so forth.

While we could say that interest rates will go up or down, or that growth will be high or low, that's more of a tactical question. If you are thinking strategically, then you need to have weights in each of these quadrants to make sure you are diversified across plausible scenarios.

Rob Waldner: Let me build on what's been said before. I completely agree with characterizing these assets based on the growth-inflation environment that we are in. We think that we will be in an ongoing growth-challenged environment, which we don't think is well-understood by investors. The primary reason we believe that will be so is the tremendous amount of debt growth across all countries — not just China, which receives most of the attention.

Debt is growing across many countries that have traditionally been pretty healthy — Korea, Thailand, China, of course. This growth in debt over the past seven or eight years has been fueled to some extent by the choices of policymakers. The key here is that the debt is in the household sector and in the government sector, and that is going to be challenging for global growth going forward.

The debt fueled some of the growth we saw in emerging market countries going back a decade, but going forward that will be challenging. We see global growth as being slower than it has been in the past — and crucially, slower than the market expects. We are in what we would characterize as a credit cycle rather than an economic cycle.

We are used to thinking about the global economy as going through five-to-seven-year economic cycles, driven by policymakers. Now we're in the slow part of a credit cycle, which is a much longer cycle, and will require an extended period of slower growth, involving deleveraging globally. As a result, you would expect commodity pricing to be poor.

P&I: ***How should investors be thinking about inflation?***

Dan Dektar: The risk of inflation — it's a risk! Inflation with growth is different from inflation without growth, sometimes called stagflation. I agree that low growth means a lower risk of inflation. But it hasn't gone away completely. The price of inflation protection is cheap.

In a probabilistic sense, investors are paying too much for deflation insurance and leaving inflation securities behind. So although high inflation is unlikely to occur, we think the market's pricing is even lower than the likelihood.

Chris Diaz: Another way to look at this is through the labor market. We're getting to levels that the Fed considers full employment, at least measured by the unemployment rate. To date, we've seen little or no wage pressure, which is a global phenomenon, so if we begin to see those pressures, that would alter our view around the importance of inflation insurance.

Rob Waldner: Given what I have already said about debt and deleveraging, we think inflation is not going to be a factor for global investors for quite a few years. It's often tied to the demographic cycle. We're now at a point in that cycle where working-age populations are shrinking. So we don't see an impetus for inflation.