MCCA Perspectives: After Two Years of Fed Tightening, What's Next For Taxable Fixed Income Portfolios?

After an almost 100 basis point run-up in the 10-year Treasury bond yield from September 2017 to late February 2018, and a retesting of the 3% level last seen in December 2013, many market participants are declaring the official start of a 'bear bond market' and reevaluating return expectations for the next few years. The 2-year Treasury yield is currently trading at a ten-year high (2.31%) while the 10-year has hovered between 2.80% and 2.90% over the past month.

Following strong performance in 2017, the investment grade U.S. bond market has returned -2.0% in 2018 through mid-March, representing the worst start to the calendar year since 1991. Apart from rising interest rates, a large component of the performance drag comes from widening credit spreads. Most notably, after hitting an eleven-year low on February 1st of this year, investment grade corporate bond spreads have since reversed course, increasing +0.20% (20 basis points or bps) since that time. Further, the Federal Open Market Committee (FOMC) voted to boost the Fed Funds rate on March 21st by +0.25% to 1.75%, and we expect additional headwinds for bonds as new Fed Chairman Jerome Powell appears on pace to raise interest rates another 50 to 75 basis points by year end.

The likelihood of both rising interest rates (and attendant lower bond prices) and the possibility of credit spread widening leaves fixed income portfolios more vulnerable to lower returns in the near term as a result of mark to market adjustments. But for investors with a long-term orientation, however, the ability to reinvest proceeds at gradually higher yields amid strengthening economic conditions and attendant low default rates on corporate bonds provides an opportunity to offset modest price depreciation with greater levels of income and the potential to achieve positive total returns over time.

Recent Fed Meetings and Rate Changes

FOMC Meeting Date	Result	Fed Funds Target Range
Dec-15	+25 bp	0.25%-0.50%
Dec-16	+25 bp	0.50%-0.75%
Mar-17	+25 bp	0.75%-1.00%
Jun-17	+25 bp	1.00%-1.25%
Dec-17	+25 bp	1.25%-1.50%
Mar-18	+25 bp	1.50%-1.75%

A Long Time Coming

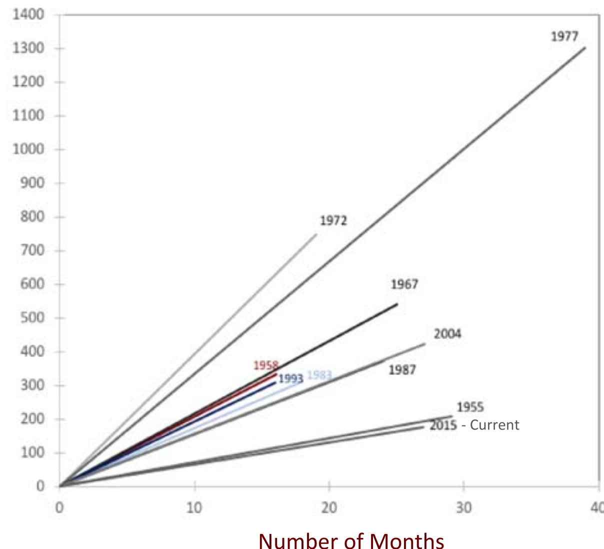
Given the significant financial shocks resulting from the Great Recession, the Federal Reserve has taken measured and deliberate steps since 2008 to ensure that the U.S. economy experiences a smooth transition back to what would be considered "normal" monetary conditions. Recent shifts in monetary policy have been communicated to the public well in advance of implementation to prevent disorderly selloffs, such as that briefly experienced during the "Taper Tantrum" in 2013. At that time, after hinting on several occasions about the first interest rate hike in over ten years, the Federal Reserve finally took steps to normalize monetary conditions when it decided to raise the Federal Funds rate from 0% to 0.25% following its December 2015 FOMC meeting (see chart above). In the meeting's minutes, the Committee stated, "there has been considerable improvement in labor market conditions this year, and it is reasonably confident that inflation will rise, over the medium term, to its 2 percent objective." Indeed, unemployment had dropped from a

Recession-era high of 10% to just 5% while annual GDP growth of 2.6% added to the improving economic sentiment.

The Fed had enough foresight, however, to quantify their inflation expectations. Indeed, core inflation has remained anchored below their stated 2% target level. Persistently low readings of inflation over the current economic expansion that began in 2009 has emerged as the driving force behind the slow pace of interest rate hikes and return to monetary policy normalization. In fact, the current tightening cycle represents the longest and shallowest Americans have experienced since the 1950s.

Ten Longest U.S. Tightening Cycles Since 1955

Basis Points



To put this in perspective, there have been 14 tightening cycles since 1955, lasting 1.5 years on average, across which the Fed Funds rate increased by an average of 427 basis points (4.27%). If the Fed under Jerome Powell follows the "Dot Plot" (FOMC members' estimates of the timing and amount of future rate increases) as laid out on March 21, the length of the current tightening cycle will be second only to the period 1977-1980, when then Fed Chair Paul Volcker aggressively raised interest rates by a record +1300 basis points (13%) to break what had been a cycle of extremely high inflation. Of course, the economic environment is very different today, and raising short-term interest rates from a zero-bound starting point in late 2015 means that the Fed may have considerable latitude before corporate and retail borrowers alike feel unduly impacted by higher interest rates. The net increase in rates of +338 basis points (3.38%) implicit in recent Fed projections of "terminal" (cycle-end) interest rates would be below-average relative to past rate tightening cycles.

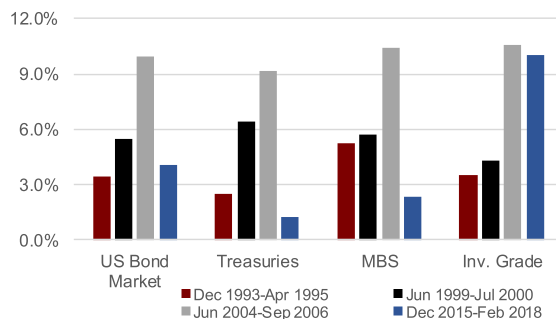
U.S. Fixed Income Performance, December 2015 to December 2017

As most investors know, the components that make up a bond's (or a bond portfolio's) periodic total return are its underlying coupon income and changes in price. Bond market prices are, in turn, influenced by two principal components: changes in Treasury market yields and changes in credit spreads (the yield premium demanded by the market over comparable risk-free Treasury securities).

Credit spreads can vary significantly based on overall market conditions. For example, during the early stages of an economic recovery, fixed income investors tend to benefit from both tightening credit spreads and falling Treasury yields as Fed officials look to implement accommodative monetary policies (i.e., lower interest rates) to encourage economic growth. In contrast, a desire to moderate the pace of strong economic growth by raising short-term interest rates can combine with widening credit spreads (as investors become more concerned about borrowers' creditworthiness) during the late stages of an economic cycle, worsening bond price declines.

On this particular topic, we observe that at the onset of the prior three rate tightening cycles, credit spreads across various fixed income sub-categories were below their respective long-term medians. And the bond market's average coupon interest rates were appreciably higher (e.g., 6.75% in June 1999) than at the start of the current tightening cycle (3.20%), somewhat insulating investors against any losses resulting from a prospective widening in credit spreads.

Fixed Income Cumulative Total Returns Over Recent Tightening Cycles



A key difference in the current rate cycle that began in December 2015 is that credit spreads started above long-term averages, due in part to the dramatic fall in oil prices earlier that year that pushed bond prices down across the broader fixed income market. In retrospect, this provided a greater short-run opportunity for spread compression (and price appreciation) to have a positive contribution to bond total returns even as the Fed embarked on its first tightening policy in more than a decade.

Ongoing quantitative easing, the slow pace with which the Fed boosted rates, and global investors' reach for yield also provided additional bond price support, leading to better-than-expected bond returns despite the unprecedently low interest rates that prevailed as the cycle began. Through February 2018, the taxable bond market has returned +1.8% annualized since the Fed's first rate hike in December 2015.

With the Fed now seemingly committed to boosting short-term interest rates across the balance of 2018 and in 2019, investors want to know how such activity will affect bond market returns. The bond market's current average coupon interest rate is now just 3.08%, lower than when the cycle began because some higher income bonds have matured across the last 2+ years. And credit spreads (58 basis points for the overall bond market) remain below-average.

Each tightening cycle proves different from the last, with economic, market, and inflationary conditions varying significantly. It becomes difficult, if not impossible, to predict with any precision how fixed income portfolios will fare over the current period, especially given that bond yields and credit spreads have historically followed very different patterns during rising rate environments. For instance, spreads generally narrowed throughout the 2004-2006 cycle as optimistic sentiment fueled the bond bull market, while they widened between 1999-2000 as credit conditions plateaued and fixed income investors became wary of the tech boom's sustainability.

Given such divergent patterns, we ran a sensitivity analysis to calculate plausible "Upside," "Base," and "Downside" bond market scenarios to help frame a range of possible return outcomes that investors could expect over the next year. To this end, our Base case assumes the Federal Funds rate increases by another 50 basis points this year (roughly in line with current Fed Governor estimates) to 2.25% by December 2018 and that the Treasury curve retains some steepness, with 10-year bond yields also increasing by another +50 basis points over Treasury Bills to reflect rising

economic growth and inflation expectations. In terms of credit spreads, because most fixed income sub-categories are currently trading below their respective longer-term medians and are mean-reverting over time, we assume greater downside risk (i.e., that credit spreads are more likely to widen by more than they would tighten) in our analysis. Specifically, we project that overall bond market spreads widen by nearly 50 basis points (0.50%) from 2017 year-end levels in a Downside scenario, but are little changed in our Upside scenario.

2018 Bond Market Total Return Scenarios

		Potential Year End Scenarios		
	12/31/2017	Upside	Base	Downside
Average Market Yield	2.73%	3.09%	3.21%	3.47%
Average Bond Coupon	3.06%	3.08%	3.08%	3.08%
Average Credit Spread	41	49	61	90
Price Return		-1.70%	-2.40%	-4.10%
Coupon Return		3.08%	3.08%	3.08%
Total Return		1.38%	0.68%	-1.02%

Combining these credit spread and Treasury yield curve assumptions, we calculate annual total returns for a core taxable fixed income portfolio ranging between a low of -1.02% and a high of nearly +1.40% for all of 2018 (see chart above). In comparison to YTD market returns of -2.0%, this analysis suggests that the “worst” of this year’s taxable bond market returns may already be behind us.

Conclusions

Although forecasting future interest rates is fraught with difficulty and uncertainty, we find it useful to think through plausible scenarios to help illustrate the general direction of returns on bonds moving forward to set realistic performance expectations. We believe the current market environment means we are entering a time during which it will become even more challenging to achieve returns approaching those enjoyed over the past several decades.

While the outlook for bonds is muted, we continue to believe that a well-managed allocation to fixed income securities will provide positive portfolio benefits over time. We expect that overall outcomes will be enhanced as allocations to fixed income markets lower the variability of returns in comparison to an all-equity portfolio and produce a comparatively steady and possibly rising source of periodic income.

MCCA Investment Strategy Team
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Past performance is no assurance of future results. The fixed income returns provided are not representative of the actual performance of an individual portfolio or strategy, and are not themselves directly investable. The returns provided are gross of investment management fees and expenses, and would be lower if fees and expenses were reflected. There can be no assurance that forecasted changes in Federal funds or other rates, such as interest rates, or forecasted investment returns, will be achieved. ***The information contained in this report is neither an offer to sell nor a solicitation of an offer to purchase any securities. Such an offer will only be made to qualified purchasers by means of a confidential private placement memorandum and related subscription documents.***