STATERA
ASSET MANAGEMENT

Commentary: February 2018

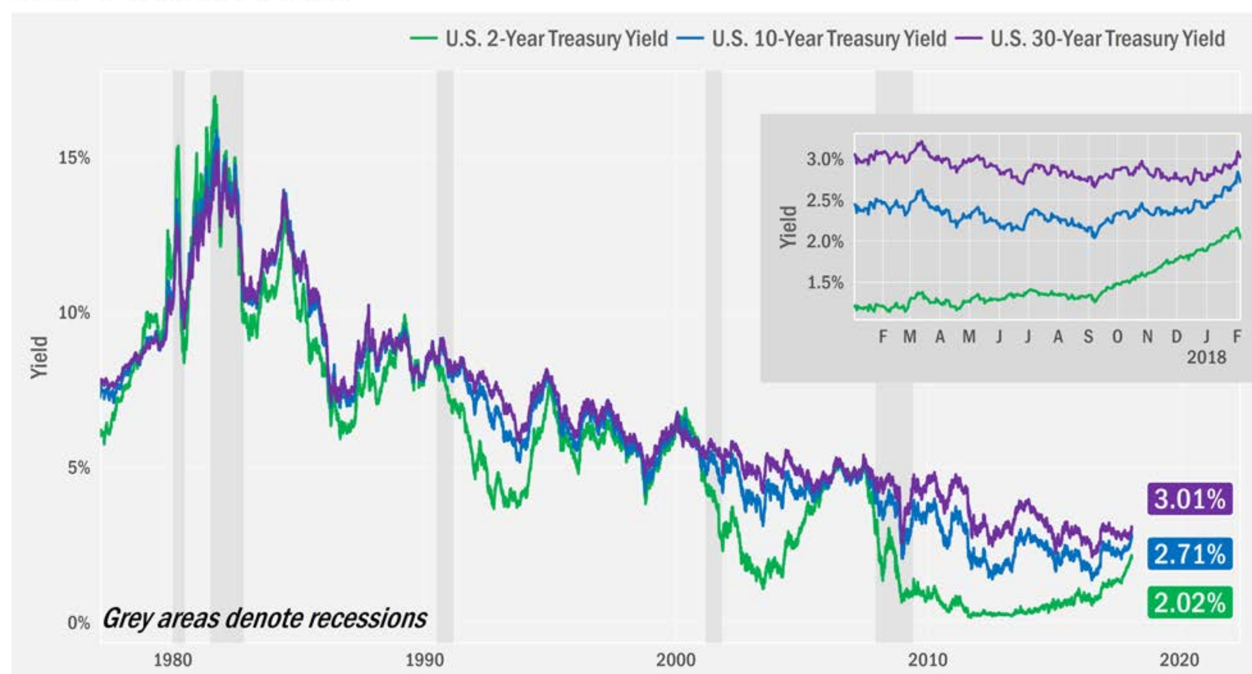
RATES IN MOTION

With the equity market plunge the talk of the trade over the first week in February, pundits offered a diversity of explanations as to why stock prices had turned so suddenly and a range of expectations for what's to come. Though many pointed to the surge in interest rates as a reason for the downdraft in equities, less discussed was the impact on the rate shifts to fixed income investors. Though the sharp decline on February 5 led to a flight to relative safety in bonds, we acknowledge that the recent spike in yields still has negatively impacted fixed income returns in the near term. Even so, we continue to welcome higher rates as both a signal of a more properly functioning economy and as means for more fruitful long-terms returns for bond investors.

Charting the Surge

Though still very low in the context of history, domestic bond yields have marched higher since the summer of 2017, with that pace having picked up markedly in the past few months. Detailed in Figure 1, the 10-Year U.S. Treasury bond yield hit 2.84% on the first Friday in February, a level not seen since January 2014. The run furthers a trend set in motion after the U.S. presidential election in 2016, the results of which heightened expectations for more favorable policies toward investment and macroeconomic growth.

Figure 1: U.S. Treasury Yields



From 02.15.77 to 02.05.18. SOURCE: Bloomberg

Adjusted Expectations

The U.S. Federal Reserve is tasked with fostering a stable environment for macroeconomic growth[1], primarily by targeting levels of interest rates in the broader economy. Lower rates can be seen as "accommodating" growth, while higher rates can be seen as "restricting" growth. The theory goes that lower rates make debt less expensive (lower interest payments on loans and newly issued bonds), which fosters investment that may, in turn, result in faster macroeconomic growth. Seen in reverse, higher rates are thought to slow macroeconomic activity. The Fed thus seeks to lower rates when it wants to enhance conditions for growth in macroeconomic activity and seeks to increase rates when it wishes to tamp down the potential for growth.

In December 2015, after nearly eight and a half years of generous monetary policy and with trends in inflation and unemployment nearing levels they consider healthy, the Federal Reserve figured the broader economy sufficiently fit for a less supportive stance. As a result, the Federal Reserve's Federal Open Market Committee (FOMC) initiated its first increase in its federal funds interest rate target[2], which represents the agency's notion of a proper overnight interest rate for bank-to-bank lending. Since then, the FOMC has lifted that target four additional times to its present range between 1.25% and 1.50%.

Worries Inverted

Even though Fed policy still may be seen as broadly accommodative, one can find measurable concern that the Fed might be raising rates too early. The data don't seem to support that case, though, as trends in the broader economy remain positive, despite the less supportive stance. Unemployment in the U.S. continued to fall with the latest jobs report. More notable was the increase in wage growth of 2.9% year-over-year in January, which followed an upwardly revised 2.7% gain in December. With domestic inflation hovering about the declared 2% target, these data came in as prospects for growth abroad seem increasingly upbeat. As it turns out, these more positive macroeconomic statistics, in addition to fresh U.S. tax policy that, too, may boost employment, growth and inflation, may have investors a bit worried the Fed actually may need to pursue a quicker pace toward a more normal interest rate environment. That is, instead of worrying about the Fed being too quick to move toward a more normal interest rate environment, concern may be growing that the Fed's current approach could prove too slow.

All Investing Carries Risks

Has lower unemployment finally given employees the upper hand in wage negotiations? Might inflation move above the comfort zone as the economy begins to overheat? Will the increased supply of government debt related to the tax policy change crowd out private investment and force rates to restrictive levels? Instead of focusing on such questions, which at present remain more rhetorical in nature, we'd rather highlight a more important takeaway from recent trends in the bond market. The enhanced volatility and general downward

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[1] The U.S. Federal Reserve operates under a mandate to foster full employment and to maintain price stability and moderate long-term interest rates.

[2] The fed funds rate is the rate at which banks loan each other funds overnight. The Federal Reserve establishes a target for this rate, seeking to modulate macroeconomic activity. A very helpful primer on the workings of the Federal Reserve can be found here: https://www.stlouisfed.org/in-plain-english

trend in returns since last summer are reflective of the fact that all investing—in equities, in bonds and otherwise—carries risks. Those risks include the very fact that we no more can know what the future holds than we can know what everyone else is thinking about what the future holds. The upshot is that investors may expect to be compensated for taking on investment risk, but such compensation is not guaranteed over any time frame, let alone one as short at six months.

Still a Net-Positive Take

On the flip side, the strong bond rebound as equity markets plunged on February 5 exemplified the strength of fixed income as a portfolio diversifier. Though the impact on the fixed income side of portfolios still has been negative over the shorter-term, we offer the reminder that, generally speaking, risks associated with equity investing are substantially higher than those related to fixed income investing. Even so, the consideration of all investment risk—equity, fixed income and other—should be core to the assessment of appropriate levels of market exposure. We understand it might be tough to figure out in advance of actual market tumult what level of volatility and potential downside might be acceptable. Even so, we should attempt to gauge our willingness to tolerate market uncertainty as best we can so that any surprises do not discourage a focus on meeting long-term goals. Readers may wish to reach out to an advisor to pursue such a discussion.

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