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Fed rate rise talk puts focus on fixed-income markets

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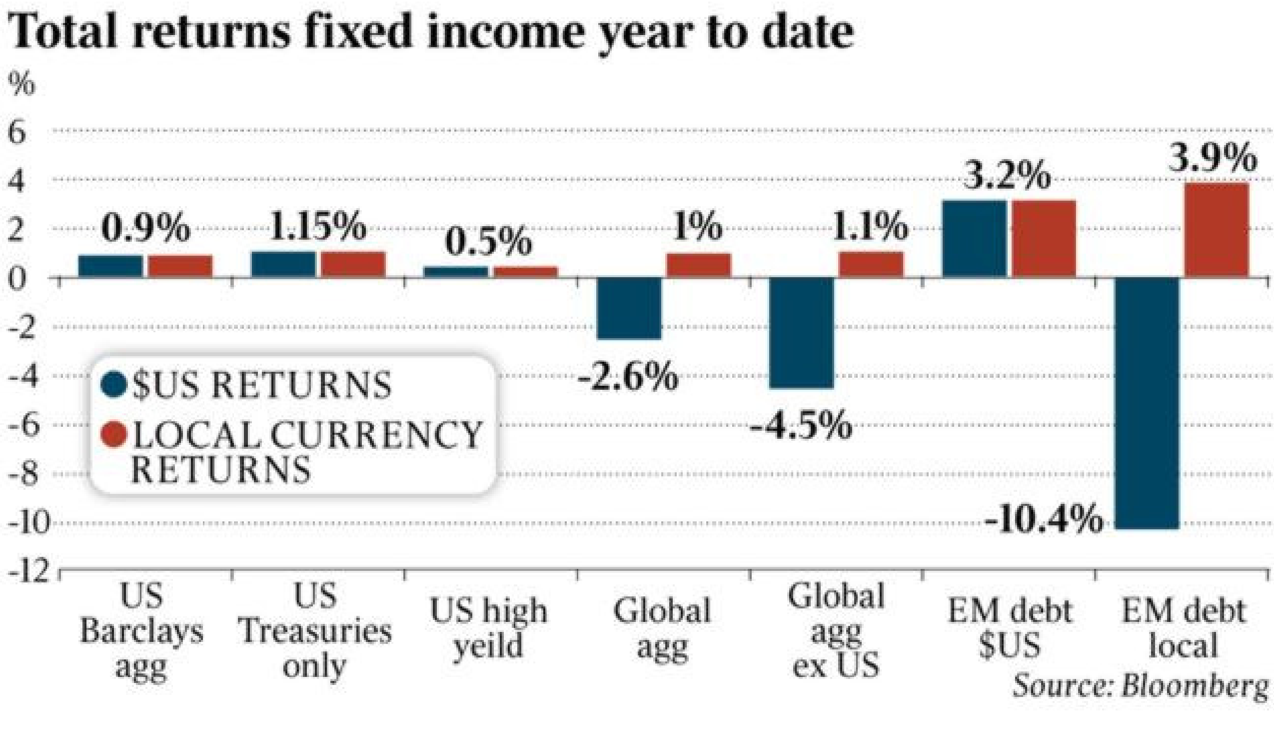

Returns on fixed income year to date. Source: TheAustralian

Though almost all agree that the US Federal Reserve will raise interest rates in less than a month's time, the greatest uncertainty and source of division within ultra high net worth wealth at the moment surround the future of traditionally stalwart fixed income investments.

Fixed-income assets include bonds, credit and debt instruments and they continue to remain the backbone of most successful long-term investment portfolios.

The rubric for experienced UHNW investing has always been: “Bond markets lead, everything else follows”.

Within many UHNW multi-asset portfolios, as volatility-adjusted expected returns do not look much higher than those found in cash alternatives, there has been a recent propensity to seek shorter-duration bonds and, as much as possible, remain “underweight” these allocations altogether within portfolios. This in itself has caused much of the division within the wealth industry and raised questions about the role of bonds following a period of quantitative easing and before an interest rate tightening cycle.

During the last three US Federal Reserve tightening cycles — 1994, 1998 and 2004 — the total first-year return on seven to 10-year maturity bonds, from the time of the first hike, historically averaged around 80 basis points, or 0.8 per cent.

At the conservative end of the risk-and-return spectrum, such returns were both appropriate and acceptable, given that the underlying US economy was returning from recession or crisis.

In all three cycles, “coupon” income — annual interest rate paid on a bond — has buffered the decline in prices, but most importantly, at the current level of benchmark coupons, it appears a yield-to-maturity increase of a little more than 10 basis points, or 0.1 per cent, could push returns below this historical norm.

As every investment must earn its keep within any given portfolio, what has become challenging for many to assess is how to best prepare for a rising interest rate environment, particularly as liquidity, volatility and inflation metrics now behave very differently than they traditionally had, preceding the Great Recession.

There are several key reasons for these changed relationships:

The most significant has been the way that firms within the fixed income sector — including investment banks, brokers and proprietary firms, such as Pimco — have shifted from principal-based models, where firms hold inventories and sell them as required, towards more agency- based models, which primarily match buyers and sellers without at any stage warehousing inventory.

This change occurred because progressive fee deregulation in the US saw core profitability from commission income decline from 61 per cent of industry revenues in 1965 to 40 per cent in 1976 and to 16 per cent in 1990 and thereafter the economics of holding inventory no longer made commercial sense. This shift also led many firms to push for new ways to take on higher leverage and risk and this all culminated in 2004, when the US Securities and Exchange Commission removed its Net Capital Rule, which had limited broker-dealer leverage at 12-to-one, since 1975.

As well as these structural changes making it more difficult for bond dealers to carry inventory, it also meant that market-making activities became limited, with the result of shallower markets. Shallow markets affect liquidity and less liquid markets often exhibit higher levels of volatility and variance.

This volatility, has however, been dampened across fixed income markets in recent years because of the magnitude of the US Quantitative Easing programs, which saw the US Federal Reserve purchase up to $US4.5 trillion worth of bonds, that would otherwise have been bought and held by the private sector.

But now that these programs have finished and there is an expectation that interest rates will rise, the question being asked by UHNW investors is not only how much volatility will return, but also what path will US interest rate hikes take?

In answering this, a useful indicator has often been found by looking to the "US Fed Funds Rate" futures contract. This contract suggests the market believes the Fed Funds rate will be about 85 basis points, or 0.85 per cent by December 2016, implying an additional two hikes in the next calendar year.

More interestingly, the forward contracts suggest that in 2017 the pace of rate hikes will slow to a cumulative 50-75 basis points, or 0.5-0.75 per cent, leaving policy rates just below 1.5 per cent by December 2017.

The other component that affects the value of bonds and fixed income instruments is inflation, and given that core US inflation has been difficult to gauge since the oil shock of 2014, UHNW investors have been exploring better ways to assess this variable.

Presenting a paper titled "Permazero", US FOMC (Federal Open Market Committee) member James Bullard last week suggested that, to account for the outsized oil price shock that occurred during 2014, "a measure that tries to control for this effect is the Dallas Fed's trimmed mean inflation rate, measured year-over-year".

As this measure is currently running at 1.7 per cent, just 30 basis points, or 0.3 per cent, below the FOMC's inflation target of 2 per cent, Bullard argued that this measure met the committee's mandated goal, which implies the likelihood of a rate rise at their next meeting in December.

After a 32-year rally in core bonds and during a time when there is some legitimate concern surrounding the direction and pace of US monetary policy normalisation, it is imperative an agile approach is taken when facing fixed income markets.

JPMorgan Private Bank chief information officer Richard Madigan has summed it up best: "Fed communication is frustrating markets. The Fed needs to either raise policy rates or stop saying it intends to do so. Markets can then adjust expectations around that."

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