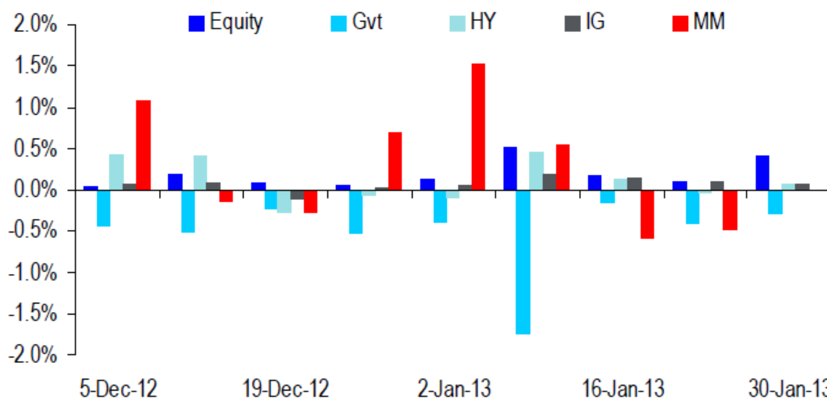
clearwater ADVISORS

MARKET Commentary

The Great Rotation

Now that the immediate sense of urgency over the "fiscal cliff" and "debt ceiling" has been assuaged, market participants are entrenched in an entirely new debate: *The Great Rotation*, or the mass exodus of investors out of fixed income and into equities. Early signs of a reversal in a thirty-one year bull market for bonds and an impressive beginning to the year for equities have many market participants convinced that this rotation has begun in full force. With the threat of rising long-tern yields, analysts fear this may spell impending doom for the bond market; but should fixed-income investors be overly concerned?

Figure 1: Mutual Fund Flows of Various Asset Classes



Source: Citi Research

While *The Great Rotation* certainly has the potential to impact the fixed-income markets in a meaningful way, we believe the doomsday rhetoric is overdone and the negative effects of such a rotation for the *diversified* fixed-income investor will be both measured and gradual. Ironically, the real risk for short-duration investors will not be driven by investors rotating out of fixed income and into equities pushing yields higher, but by long-duration, fixed-income investors seeking increased safety in the short-duration market. This could put even further downward pressure on money market yields. This would prove yet another thorn in the side of money market investors frustrated by the FOMC's *Zero Interest Rate Policy*, but these investors have learned several times over how to adapt to unfavorable market conditions over the last five years, and more importantly, they have learned to prosper in spite of it. This time will be no different.

In this month's market commentary, we outline how investors should position against this potential rotation and lay to rest some of the myths regarding the scale of its implications for fixed-income investors.

February 2013

US Treasuries

As of 31-January

Benchmark	Yield
3 Month	0.07%
6 Month	0.11%
1 Year	0.13%
2 Year	0.26%
5 Year	0.88%
10 Year	1.99%
30 Year	3.17%

Bank of America/Merrill Lynch Indexes

31-Dec to 31-Jan

Index	Return
1-3 Yr Gov/Corp ≥ A	0.04%
1-3 Yr Municipals	0.21%
1-3 Yr Agencies	0.03%
0-3 Month UST	0.01%
S&P 500	5.18%

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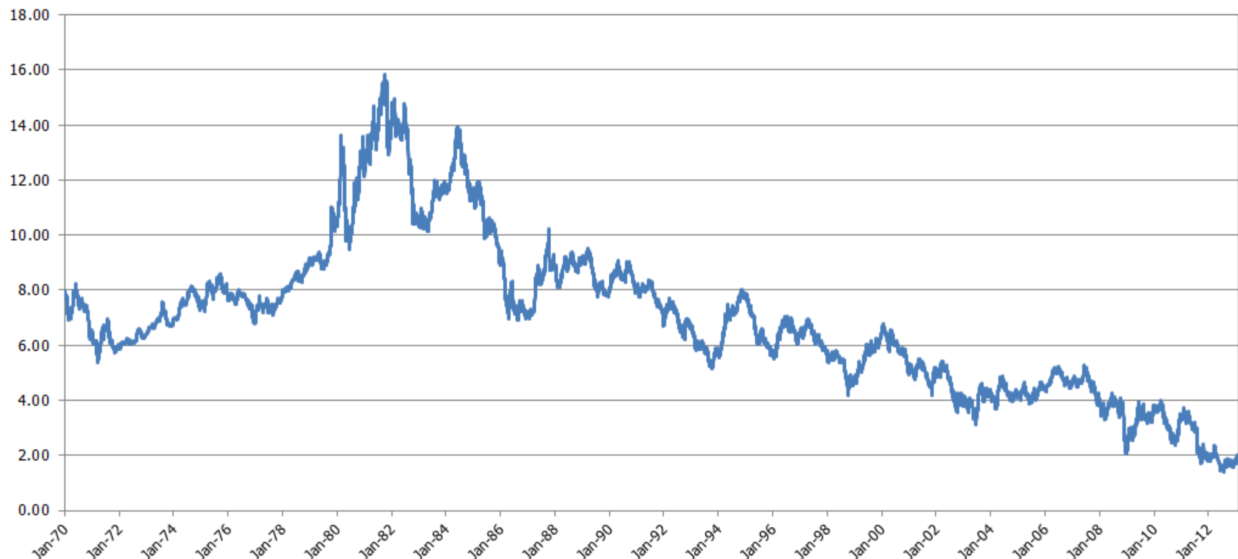
Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities, Wall Street Journal

The Great Rotation Explained

The Great Rotation centers on the belief that investors (i.e. those with the ability to shift between asset classes) are growing increasingly concerned about the low absolute level of interest rates and the potential for rising rates due to positive economic catalysts on the horizon. Market participants who subscribe to this belief contend that investors should migrate away from fixed income—an asset class they poured money into at an unprecedented rate following the advent of the credit crisis in 2007—and into equity and equity-like investments, which they believe have greater long-term performance potential.

According to these strategists, the market is at a fulcrum point in investor risk appetite. The bull market for bonds has spanned an incredible thirty-one years, beginning on September 30, 1981 when the 10-year Treasury note reached 15.84% and concluding on July 24, 2012 when it reached an all-time low of 1.39%. While the journey has not been one directional (a straight-line path lower), the long-term trend paid investors to be long duration.

Figure 2: 10-Year U.S. Treasury Yield during its Incredible Bull-Market Run



Source: Bloomberg

Since reaching all-time lows in July 2012, however, the U.S. Treasury 10-Year yield has been on a gradual uptrend, reaching 2.01% as of January 31st, 2013. The Bank of America/Merrill Lynch Current 10-Year U.S. Treasury Index recorded a 3.62% decline during this period; the S&P 500 index, by comparison, recorded a 13.30% return. Proponents of *The Great Rotation* contend that this trend—stocks materially outperforming bonds—will likely continue as the economy recovers and interest rates normalize accordingly. They argue that the wind out of the sails of fixed income has now become a powerful tailwind lifting equity markets to relative highs.

Unbridled Enthusiasm

The former Chairman of the Federal Reserve, Alan Greenspan, may attribute the exceptional equity performance to begin 2013 as "irrational exuberance;" we, on the other hand, prefer the Seinfeld Kramerisms of "unbridled enthusiasm" or "cockeyed optimism." Truly, we have grown concerned that investors are not viewing the recent equity gains in the proper context. This would hardly be the first time such an event has occurred.

In January according to TrimTabs, investors moved $77.4 billion into traditional stock funds and ETFs eclipsing the prior record of $53.7 set in February 2000. The past record, in what has become an infamous statistic, corresponded with the very height of the dot.com bubble. The elation that equity-specific doomsday events (i.e. "fiscal cliff" and "debt ceiling") have been temporarily averted is understandable, but we warn investors not to interpret short-term equity gains as a precedent for a sudden and broad rotation out of fixed income.

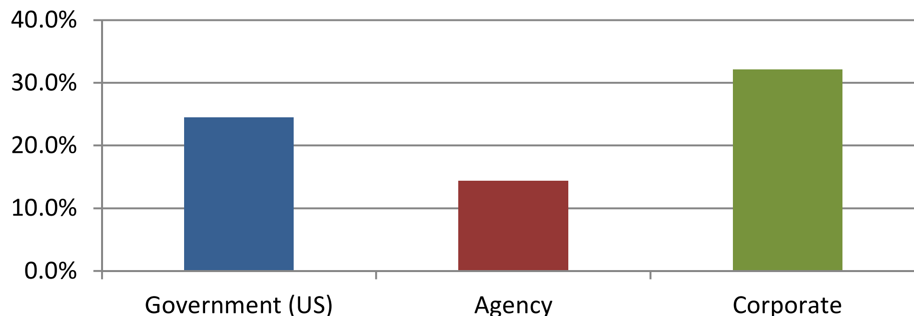
Treasuries Will Suffer, But Credit will Prosper

We are well aware that interest rates will eventually rise as the economy recovers, and we also understand the implication: there will be pain—and plenty of it. This pain, however, will be concentrated with investors who have failed to take a *diversified* approach, and a steady rise in interest rates will affect select sectors of the fixed income market more than others. For example, with interest rates as low as they are currently, the marginal carry (or income) of long-duration rate product (e.g. a 10- year U.S. Treasury note) will do little to offset the significant price movements associated with rising rates when they happen, especially if the rise is more rapid than the market anticipates.

Additional historical perspective may help to frame our thesis more fully. On December 30, 2009, the 10-year U.S. Treasury yield reached—what was at the time—an all-time low of 2.05%. Low absolute yields and rising rates in 2009 resulted in the worst yearly performance for the Bank of America/Merrill Lynch Current 10-Year U.S. Treasury Index in its history, returning -9.71%. During that period, the 10-Year U.S. Treasury yield rose an amazing 163 basis points, despite no FOMC rate action. By contrast, in 1994 the 10-Year U.S. Treasury yield rose an incredible 203 basis points, yet the same Bank of America/Merrill Lynch index posted a return of -8.29%. The difference in performance for these two time periods rests in the fact that interest rates were much higher in 1994 and carry comprised a larger portion of a security's return. While attention is rightly focused on the effects of duration on a portfolio's return in a rising rate environment, investors should remember that carry serves as a critical component in offsetting price volatility in a material way.

In the current environment, carry is not something easily obtained in rate product (i.e. Treasuries and Agencies). Treasuries offer little protection against price movements associated with rising rates, and Agencies remain at historically rich valuations. Fixed-income investors should look to higher-yielding spread product, such as corporate bonds, to increase portfolio carry and help offset any price volatility associated with rising rates. Recent data provided by Clearwater Analytics suggest that many corporate cash investors understand this principle, with corporate bonds making up the largest share by category of corporate cash allocations.

Figure 3: Corporate Cash Investment Allocation by Sector as of February 1, 2013



Source: Clearwater Analytics/Wall Street Journal

Another consideration lost in *The Great Rotation* debate is the fact that what is good for equities is not necessarily bad for fixed-income. This is particularly true for credit. History shows that the performance of equities and credit spreads are positively correlated. Positive economic conditions, greater certainty in domestic fiscal policy, and continued monetary stimulus will lift equities and corporate credit alike. In a recent research

note, Goldman Sachs supports this thesis and goes on to write that corporate credit will outperform other fixed-income sectors as the economy improves. Goldman also notes that even in the periods where fixed-income bond funds have experienced their worst outflows, the amount has been manageable and negligible to the performance of corporate bonds as a whole.

Observing past periods of rising interest rates, short-duration mandates have held up admirably, striking the proper balance between higher carry than rate product and frequent portfolio turnover. The short nature of these portfolios has allowed investors to reinvest at higher rates faster than portfolios further out the yield curve in periods of rising rates. The higher carry associated with spread product has also protected the portfolio from unexpected negative price movements.

Figure 4: Historical Index Performance during Sustained Periods of Rising Rates

Index	2009	1999	1994
Current 10-Year Index	-9.71%	-8.25%	-8.29%
U.S 1-3 Credit ≥A Index	11.57%	3.66%	1.06%
U.S. Broad Market	6.12%	-0.87%	-2.75%
U.S. Corporate Index	19.76%	-1.89%	-3.34%

Source: Bank of America/Merrill Lynch

Diversified investors with mandates in the 1-5 year space should not be overly concerned about the implications for rising rates—the fact that long-duration investors are looking to place an increasing amount of funds in this space should provide some solace. Additionally, with the FOMC providing additional color on future monetary policy to stimulate growth, we do not foresee a sharp rise in short-interest rates in the immediate future.

Looking Forward

Equity returns and the threat of rising interest rates will garner much attention in 2013, but fixed-income investors should not be afraid. For short-duration investors, a diversified portfolio with an emphasis on carry should provide a boon to investment portfolios despite the challenging market environment. Technical flows into the front-end by traditional long-duration fixed-income managers will further support short-product asset prices in the near term, but put additional pressure on short-term yields in the long run. With resolution to impending budget talks unpredictable, investors should continue to lean on FOMC policy and credit fundamentals to drive investment decisions.

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