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MARKET Commentary

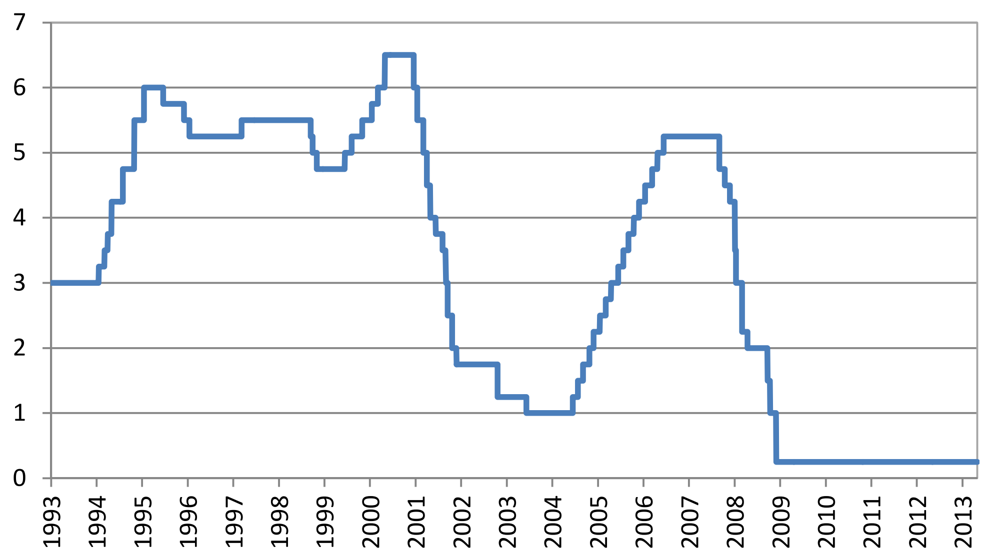
The Specter of Higher Yields

U.S. Treasury bond yields recently reversed much of their year-to-date decline raising investor concerns about the specter of higher yields. The Bond King himself, PIMCO's Bill Gross, jumped into the fray by calling the end of a 30 year bull market on April 29th. Short-maturity fixed income investors, including Clearwater Advisors, are faced with a potential dilemma. The prospect of escaping a very low yield environment is enticing, provided the transition is orderly and gradual. However, higher yields could also translate into periods of negative returns as income proves insufficient to offset declines in bond prices. In this month's commentary, we will look at historical rising rate environments, consider portfolio implications and discuss what the future could look like.

Historical Context

In the last twenty years, the bond market has endured two significant periods of restrictive Federal Reserve policy enacted by raising the Federal Funds Rate (see Figure 1). Fearing inflation, the Federal Reserve, beginning in February, 1994, doubled its benchmark rate over twelve months from 3.00% to 6.00%. The Fed hiked rates in 25 and 50 basis point increments three times and 75 basis points once over this period. Bond markets did not react well to the hikes as then-Fed chairman Greenspan in his usual opaque manner did not prepare investors for the speed of the rate increases.

Figure 1: Federal Funds Target Rate



Source: Bloomberg

May 2013

US Treasuries

As of 24-May

Benchmark	Yield
3 Month	0.04%
6 Month	0.08%
1 Year	0.10%
2 Year	0.25%
5 Year	0.89%
10 Year	2.01%
30 Year	3.17%

Bank of America/Merrill Lynch Indexes

30-Apr to 24-May

Index	Return
1-3 Yr Gov/Corp ≥ A	-0.05%
1-3 Yr Municipals	0.03%
1-3 Yr Agencies	-0.04%
0-3 Month UST	0.00%
S&P 500	3.49%

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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

Later, beginning in June, 2004, the Greenspan Fed took a more "measured" approach and increased Fed Funds 425 basis points over a two-year period capping out at 5.25% as the central bank moved into the Bernanke era.

Bond market performance differed in both instances (see Figure 2). The 1994 event, dubbed the "Bond Market Massacre", was poorly received by markets due to poor central bank communication and returns were negative for longer-duration sectors. Short-duration investors realized low returns, but were immune from the losses experienced by longer duration assets. For example, the BofA/Merrill Corporate Master and the BofA/Merrill Treasury Master Indices both declined approximately 3.30% in 1994. Interestingly, the Mortgage Master Index declined just 1.60% that same year.

Figure 2: Short-Duration Bond Index Returns

	90 Day T-Bill	1-3 Yr US Treasury	1-3 Yr US Corporate	0-3 Yr Fixed ABS	0-3 Yr MBS
1993	3.19%	5.41%	7.07%	5.33%	n/a
1994	4.19%	0.57%	1.18%	1.63%	2.18%
1995	6.03%	11.0%	11.72%	9.95%	12.49%
2003	1.15%	1.90%	5.33%	2.74%	1.83%
2004	1.33%	0.91%	1.82%	2.16%	2.80%
2005	3.07%	1.67%	1.89%	2.60%	2.15%

Source: BofA Merrill Lynch Indices

Performance during the rate increase period that commenced in mid-2004 was modestly better, save for the 90 Day T-Bill Index, than the early 1990's period due to the measured pace of increase. Again, short-duration investors did not experience losses, but longer duration assets performed better during this period as the yield curve flattened (short yields rose while yields on Treasuries 5 years and longer actually declined). Returns in 2004 for the BofA/Merrill Treasury, Corporate and Mortgage Master Indices all bested shorter duration sectors with returns of 3.50%, 5.42% and 4.74% respectively.

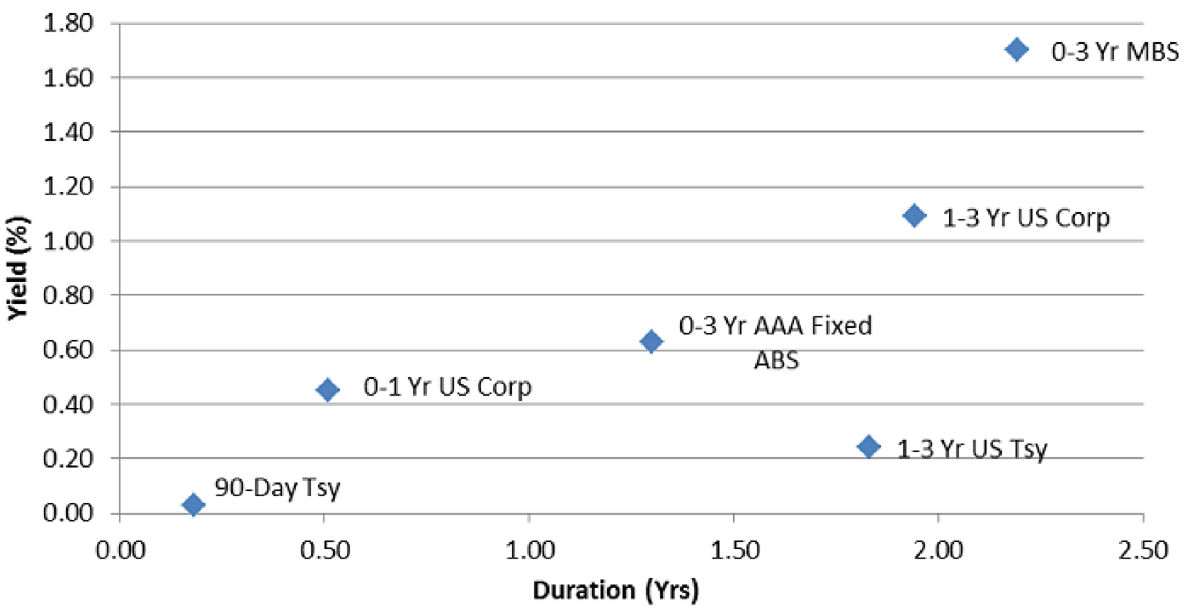
While each environment is different, looking at the historical impact of tighter policy on markets should give short-duration investors with portfolio durations around two years or less some measure of comfort especially if their portfolio includes credit and securitized products like AAA-rated credit card and automobile asset-backed securities or agency mortgage-backed securities.

Portfolio Implications

Since 2010, the prospect that rates will increase surfaces each year with building investor optimism that the U.S. economy will hit escape velocity. That optimism has subsequently faded as suboptimal growth is realized and the Federal Reserve offers continued easy policy. Rates will rise at some point, however. For a majority of Clearwater clients, higher yields will offer opportunity. The dearth of yield inside two years will reverse as the market prices in both prospective and actual rate hikes. Short duration will protect portfolios from significant, negative price moves and allow frequent reinvestment at higher rates. While we are in the middle of unprecedented monetary policy, our expectation is that the Fed will clearly communicate policy shifts while continuing to maintain low target rates for longer than expected. This should further insulate short-duration investors from negative price shocks.

As we have discussed in prior commentaries, given the low absolute level of rates it is important to insulate your portfolio from price declines by adding higher-yielding spread product, such as high-grade corporate bonds, high-quality asset-backed securities and agency mortgage-backed securities (see Figure 3). The additional income will provide a buffer from price declines associated with rising rates. Additionally, these securities generally experience the benefit of spread compression (lower risk premium) as economic activity increases, offsetting some price decline.

Figure 3: Fixed Income Market Index Yield and Duration



Source: BofA Merrill Lynch Indices & Clearwater

Looking Forward

While we expect the Fed to remain on hold for some time, investors can position portfolio composition now to maximize utility in today's low rate environment, with the added benefit being that similar positioning will also serve as a buffer against rising rates.

Recent periods of tighter Fed policy have proved manageable for short-duration portfolios. While the significant level of quantitative easing does introduce a level of uncertainty, we would expect the policy unwind to be deliberate and orderly which should mute the impact on Clearwater managed portfolios.

Please contact the desk with questions or to discuss investment opportunities and how to best navigate the current market developments.

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