Fixed Income Positioning in the Current Rate Environment

KEY TAKEAWAYS:

- Recovery from the Great Recession has been fragile and prolonged due to deleveraging
- As a result, we expect interest rates will rise more gradually than the market anticipates
- Bond investors in a rising-rate environment: Take the coupon, give a little on price

You would think that more than five years after the Great Recession ended, the U.S. economy would be in a much better place by now. And if it had been a typical business-cycle recession stemming from excess inventories, you would be right. But the Great Recession's root cause was due to overleveraged balance sheets — far too much debt at both the corporate and household level. As a result the recovery has been fragile and prolonged.

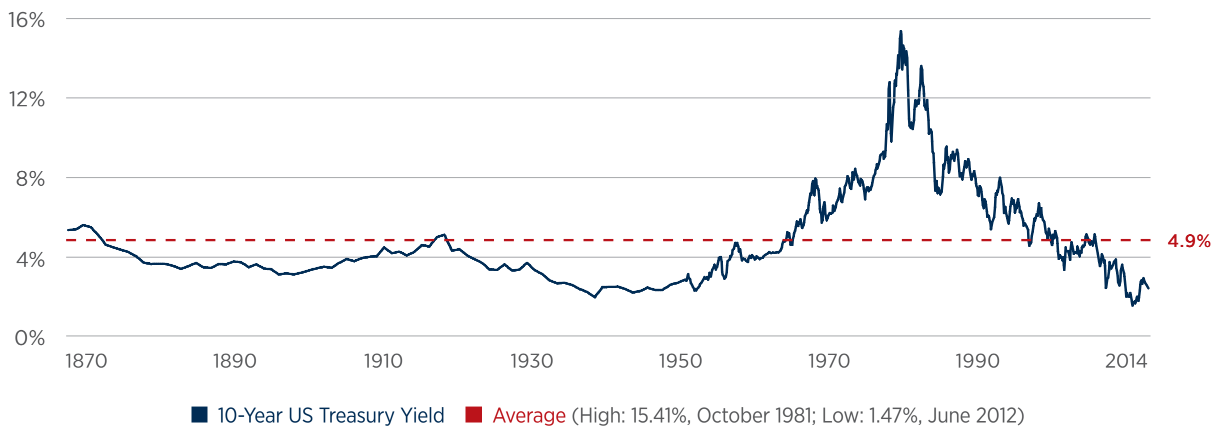
"Balance sheet recessions" are rare — only four significant examples in the past 150 years, counting the one we're mired in now. Recovery time is a crucial difference between the recession types. While it takes a couple of years or so to rebound from an inventory recession, the three previous balance-sheet recessions took 10 to 15 years to work through.

The recovery has been impeded by several related factors. Households looking to deleverage pulled back on their spending, slashing consumer demand. In turn, this led to cutbacks in staffing, production and capital spending by businesses struggling to service their own debt. In addition, capital which was allocated (or misallocated, depending on your view) to help spur lending was used instead largely to prop up the battered balance sheets of large, but insolvent companies reducing access to credit—not that many would have taken loans regardless.

We don't forecast short-term interest rates — there are too many ways to be wrong. Looking a little farther out, we expect rates to be higher in five years than they are now, and that the climb will be much more gradual than many in the market anticipate (see chart below). We see modest economic growth ahead, with a relatively low risk of the type of overheating that would prompt a harsh policy response to head off inflation.

10-YEAR TREASURY YIELD FROM 1870–2014

After Balance Sheet Recessions, Rates Can Stay Low for Lengthy Periods of Time



Source: Goldman Sachs as of August 2014

A gradual increase in interest rates is not a doomsday scenario for investors in bonds and bond funds. A few thoughts to keep in mind as we go forward:

Interest rates aren't everything.

Bond investing also involves credit risk, prepayment risk, inflation risk and reinvestment risk. And not all bonds are affected the same way when rates change. In managing the different risks, we focus on security selection — our research-intensive process seeks to be in the right sectors of the bond market and in the right securities within those sectors.

Take the coupon, give on price.

Many investors are worried about bond prices, which fall as yields rise. Most of a bond's total return, however, comes from its coupon payments, which don't change. As a bond gets closer to maturity, its price moves toward its par value, and once it reaches maturity, income-focused investors can benefit from principal reinvestment at higher coupons.

Match investment with time horizon.

Investors should consider short-term bonds/bond funds for money that's needed in the next few years. Longer-term money can be invested in longer maturity bonds, which pay higher coupons.

Keep a close eye on costs.

Years of historically low interest rates make clear the importance of investors managing their costs. Returns in a gradually rising rate environment would likely remain low for some time, so don't let expenses and taxes eat away profits. Municipal bonds/bond funds that generate tax-free income may be a good choice for efficiency.

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