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2015 PERSPECTIVES

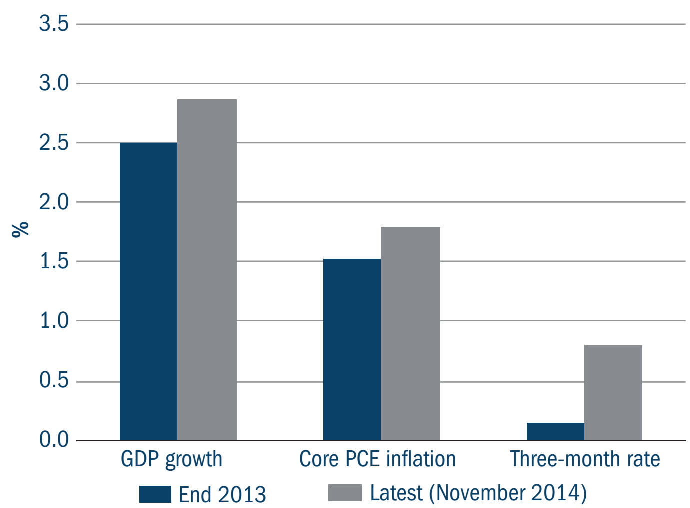
INTEREST RATES: FAREWELL, LIQUIDITY TRAP

With continued growth and further improvement in labor markets, the Federal Reserve (the Fed) looks likely to begin raising short-term interest rates in 2015, marking an end to the lengthy liquidity trap in the U.S. In our view, government bond markets are unprepared for this outcome at current yield levels. Investors should brace for a year of challenging returns.

Better domestic economy but lower rates

At this time last year we argued that the U.S. economy would continue to recover in 2014, and that gradually rising rates would prove a headwind to high-quality fixed-income returns.[1] We now know that the former view was correct, but the latter was not. Exhibit 1 shows changes in survey expectations for gross domestic product (GDP) growth, core inflation and short-term interest rates one year ahead, comparing the end of 2013 to the latest observation. Expectations for these key drivers of bond yields — growth, inflation and policy rates — all moved higher over the course of 2014.

Exhibit 1: Expectations for GDP growth core inflation and short-term rates higher on the year

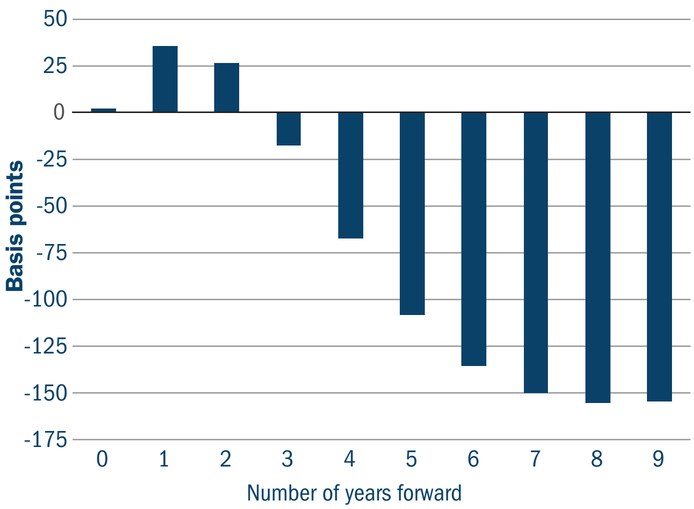


Sources: Consensus Economics and Bloomberg economist surveys

Despite this improving economic backdrop, long-term Treasury yields declined in 2014, providing a tailwind rather than a headwind to fixed-income returns. The move lower in Treasury yields was not uniform across maturities, however, and the marked changes in curve shape hint to the likely drivers of the rally. As shown in Exhibit 2, near-term forward rates increased as the market began to discount the prospect of Fed rate hikes. In contrast, forward rates three or more years out fell

sharply, and those more than six years forward fell by 150 basis points (bps).
The net result was a much flatter yield curve, caused primarily by lower long-term forward rates, rather than higher near-term forward rates.

Exhibit 2: Drop in distant forward rates drove Treasury yields lower (change, year to date)



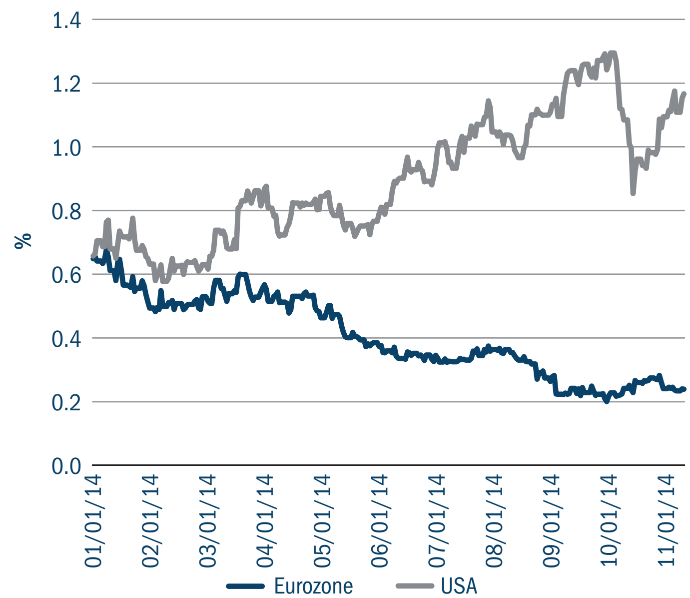
Source: Columbia Management Investment Advisers, LLC

This steep decline in forward rates has been a puzzle for many bond investors. And even in hindsight the causes are not entirely obvious. However, our research suggests two broad explanations:

1. Monetary easing outside the U.S.
Although the Fed moved closer to exiting its easing strategies, both the European Central Bank (ECB) and Bank of Japan (BOJ) stepped up their monetary easing campaigns. The ECB cut short-term interest rates into negative territory, introduced targeted long-term refinancing operations and began purchasing covered bonds and asset-backed securities. For its part, the BOJ significantly expanded its quantitative easing program in late October 2014. Central banks in a number of other countries also cut policy rates, including Sweden, Poland, Korea and Mexico.[2]

In our view, monetary easing overseas goes a long way to explaining why U.S. rates unexpectedly declined this year (Exhibit 3). The normalization of U.S. policy proved the exception rather than the rule.

Exhibit 1: Expectations for GDP growth core inflation and short-term rates higher on the year

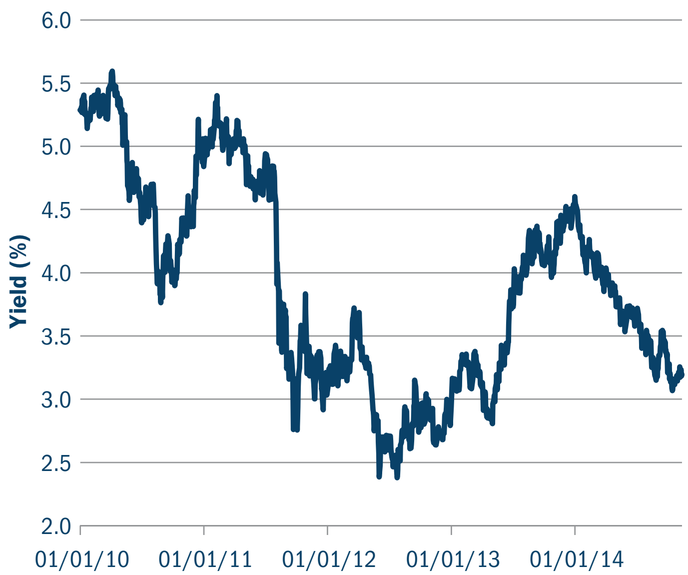


Source: Bloomberg

2. The secular stagnation thesis
Ever since Larry Summers resurrected the concept in November 2013, the idea that developed market economies might be facing a "secular stagnation" has played a role in the debate among bond investors, perhaps because the idea feels intuitively correct to many observers.

Secular stagnation is a blanket term covering many ideas about the economy. Two of these ideas, which may not be mutually exclusive, have bearing on the outlook for interest remain low even in the longer term because of slow potential growth. According to economic theory, this outlook leads to a lower neutral policy rate. (The neutral rate is where the Fed will rest short-term interest rates when the economy returns to normal.) Lower neutral policy rates in turn imply a lower "fair value" for forward yields (Exhibit 4).

Exhibit 4: 5-year forward Treasure yields have returned to pretaper levels



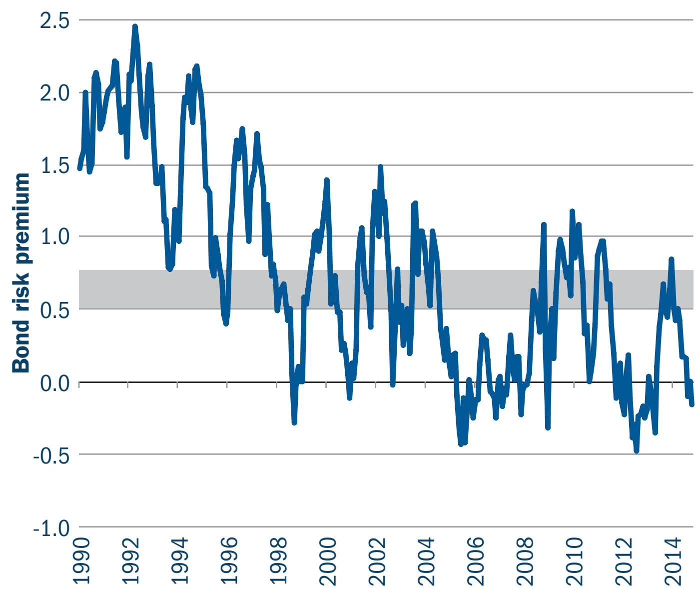
Source: Bloomberg

Time to take profit

The outlook for rates naturally hinges on these fundamentals — the U.S. economy, the global economy and perceptions about the secular outlook — as well as current market valuations. In our view, the solid returns investors experienced in 2014 are highly unlikely to be repeated, making the present a good time to take profit on long-duration fixed income.

First, valuations are currently poor. Our measure of the bond risk premium[3] turned negative in August 2014 and remains there at the time of this writing, November 2014 (Exhibit 5). In plain English, this means that 10-year Treasuries yield less than our expected cash return over the next 10 years, and investors are not being compensated for the duration risk on longer term bonds. History tells us that poor returns for interest-sensitive sectors tend to follow these periods.

Exhibit 5: Bond risk premium turned negative again



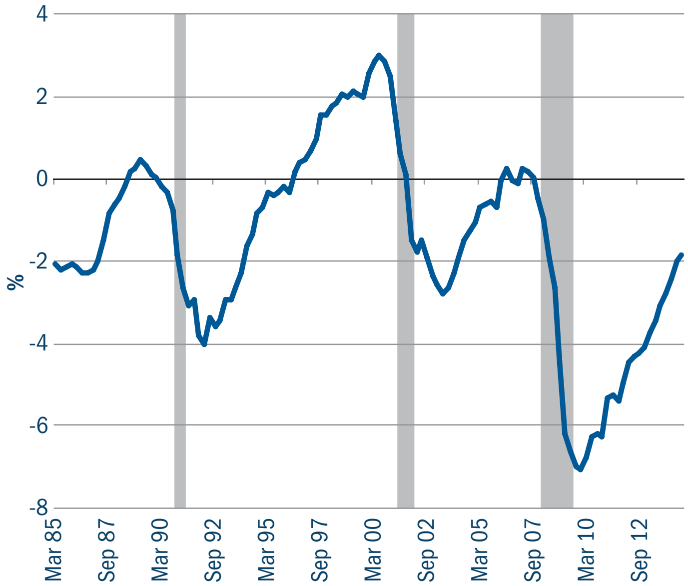
Source: Columbia Management Investment Advisers, LLC

Note: Shading indicates estimate of fair value.

Second, the cyclical position of the U.S. economy points to rate hikes next year. The conventional unemployment rate fell by more than 100 bps over the last 12 months and has now slipped below 6%. In addition, broader measures of underutilization in the labor market, such as the percent of workers on part-time schedules and the number of discouraged workers, have shown signs of improvement. Our measure of the output gap for the U.S. (the difference between the economy's actual output and its output at full capacity) is now around -2%, up from -3% a year ago (Exhibit 6). This improvement suggests continued expansion. While wage and price inflation have not firmed definitively, Fed officials are unlikely to wait for a complete recovery before beginning the process of normalization. Therefore we continue to see rate hikes from the Fed starting around the middle of 2015.

[3] For background see "The Bond Risk Premium," Columbia Management white papers, March 2013.

Exhibit 6: Steady normalization in the output gap



Source: Columbia Management Investment Advisers, LLC, November 2014

Note: Shaded areas represent recessions.

Third, we expect overseas developments to have a waning influence on U.S. interest rates, though this may take some time to play out. In developed markets, we observe a rough parity between bond yields when countries share two common features: (1) similar cash rates and (2) similar long-run growth and inflation expectations. With cash rates depressed in most places, U.S. Treasuries can seem to offer an attractive yield pick-up compared with German Bunds, for example. However, if cash rates in the U.S. start to rise or long-term macroeconomic fundamentals begin to diverge, Treasuries and Bunds will decouple.

Lastly, while it's difficult to have strong convictions about the secular stagnation thesis, we can be confident about one thing: At current valuations, these ideas need to be correct for Treasuries to generate attractive returns. We are inclined to think that the future will look similar to the past. Thus, markets might be placing too much probability on the idea that major economies will remain in a permanent funk. Time will tell.

Conclusion

Long-duration fixed-income assets generated attractive returns in 2014, following sizable losses the year before. On net, the Treasury market as a whole has returned +1% annualized since the end of 2012 (and +0.5% annualized since the low in 10-year yields in July 2012). Because of imminent Fed rate hikes and depressed yield levels, prospective returns look no better today. We recommend investors take profit in long-duration fixed-income sectors that benefited from 2014's decline in rates and look to other sources of income for their bond portfolios.

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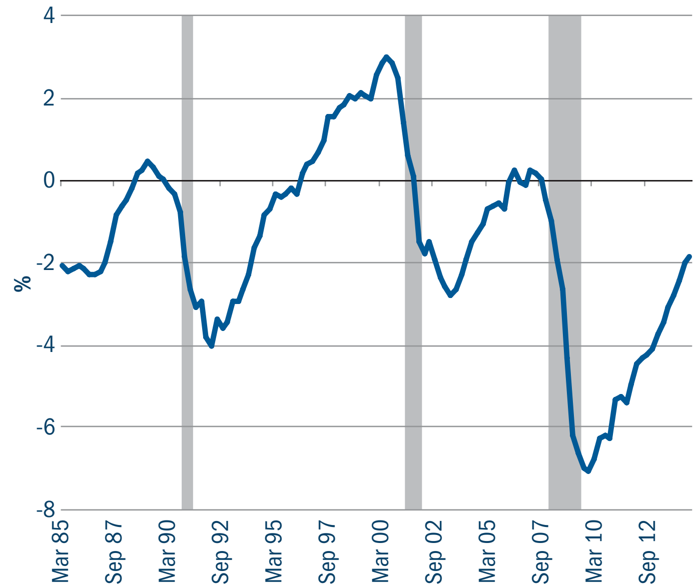

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