Fixed Income Investing After the Fed Rate Increase

The Federal Reserve recently made the announcement that they will raise interest rates. Michael Hedstrom, director of the Closed-End Fund Association (CEFA), sat down with John Bellows, PhD, CFA, portfolio manager at Western Asset, an independent affiliate of Legg Mason, to discuss the fixed income markets and the economic outlook after the Federal Reserve announcement.

John Bellows

Michael Hedstrom

The following Q&A recaps the conversation that originally took place as part of CEFA's podcast series on March 16, 2017, which can be heard at CEFA.com.

MH: Let's start with the topic that's making headlines this week. What changed over the last few weeks to drive the Fed to raise interest rates?

JB: I think you're asking exactly the right question. Remember a few weeks ago, most people thought the Federal Reserve would hike in June, and they ended up hiking in March. So 3 months earlier than most people expected. I think what changed in order to cause them to pull their hike forward were financial conditions loosened considerably. If you think about the month of February, it was a pretty impressive month, stocks were up 5%, bond yields were lower, corporate borrowing rates were lower, and I think the Federal Reserve was responding to that loosening in financial conditions by offsetting some of that with tighter monetary conditions. I do think it was financial conditions related, rather than a significant change in the economic outlook. In fact, yesterday at her press conference Janet Yellen said as much. She said there'd been virtually no change, those were her words, in the economic outlook.

I do think this was more a financial conditions motivated hike, and less to do with anything in the economic data.

MH: There seems to be more optimism on the global recovery front. Does the economic outlook call for more optimism, or are we facing some potential headwinds? What is Western's view going forward?

JB: You're absolutely right there's some more optimism. I think the data's been clear. We are in somewhat of a cyclical surge. The employment report last week was strong. You've seen very good sentiment surveys, the ISM survey, and the consumer sentiment. You're starting to see that show up in the hard data as well. I do think we've seen some better economic growth at times cyclically, it does look a little bit better.

That said, I think the headwinds are all still there and they're things that we've talked about and we've discussed as an investing community a lot over the last few years. They include demographic headwinds, low productivity time, the very low investment levels that we've seen in the corporate sector. While there's no question a cyclical surge is showing up in the data, it still could be the case that the secular environment is one of sluggish growth, and those headwinds are going to persist.

We're optimistic that the cyclical surge is going to be beneficial for corporate credit, maybe for emerging markets as well. I think you need to be very thoughtful about those longer term secular trends, and watch how those play out as well.

MH: **John, I know you believe that it's important to distinguish between the credit cycle and the business cycle, which are usually very highly correlated. Can you elaborate on this, and what are your thoughts on the credit cycle?**

JB: Michael, you're right. Usually the credit cycle and the business cycle are very highly correlated. One interesting thing though is we've gone through a mini credit cycle without any change in the business cycle, so the last few years would be one of those rare examples where the two have been disconnected. In particular, starting in mid-2014, spreads on corporate credit started widening which is to say corporate bond prices fell relative to what was happening in treasuries. That persisted until it came to a head in the first six weeks of 2016, with those spreads widening a lot. Then of course after that widening, starting in March of 2016, spreads then tightened and are now close to, but not quite back to where they were in mid-2014.

Over the last few years, even though the business cycle has been ongoing, we have seen a credit cycle, and we've seen how that can play out. I think going forward, you know what we see now is that spreads have obviously come in from where they were around this time last year, and they're still somewhat wider than they were mid-2014. I think there's less of a question about is there disconnect between the credit cycle and the business cycle. I think we're back to kind of the normal thing of evaluating where we are in the business cycle. For that as I said, we're fairly optimistic. The cyclical surge that we're seeing and the data is positive. At the same time we're fairly encouraged by the recovering corporate earnings. We think with that, dynamics aren't too problematic on the corporate side. Now that we've been through this mini credit cycle, I think you can rely more on the business cycle analysis going forward. Like I said, we're fairly optimistic there, which is reflected in our portfolios. We do have overweights in corporate credit, and as I said in emerging markets reflecting that optimism on where we are in the business cycle.

MH: **When you spoke at the CEFA Advisor Summit in Beverly Hills last month, you shared some thoughts on portfolio construction and the continued need to diversify strategies. Can you talk about what your outlook means for investors going forward, and what they should keep in mind?**

JB: Yeah, you know the message at the CEFA Advisor Summit in Beverly Hills was the importance of diversification. Thinking about the portfolio as a whole, and making sure that you had some positions that were offsetting some ballast in the portfolio. For us, that's usually been U.S. treasuries and having a little bit of additional interest rate risk. I just mentioned a moment ago, how we do have overweights in credit and emerging markets. I think those will do well in an environment of continued global growth, continued recovery and corporate earnings. I'd also say that those are positions that I think are pretty heavily owned at the moment. It raises the question of what would happen if things don't play out exactly as we expect. There's a lot of different pitfalls. There are a lot of different things that could happen including the slowdown in global growth, and maybe the new administration under delivers on some of their policies, China could have a wobble.

There's a long list of obvious things that could go wrong, and if any of those were to happen, we want to have something else in our portfolio that would outperform in that situation. So for us, that's been U.S. Treasuries. We think that makes a very nice combination, a very effective combination against the credit positions. I think the other thing I'd say about U.S. Treasuries is that there's a very strong view in the market. I'd almost say it's a consensus view that interest rates, interest yields need to go higher. You can see that in positioning. There are a lot of people who are shorted interest rates in order to express that consensus view. We just haven't been willing to join that consensus. We're more comfortable having interest rate risk as a ballast. Again, if the consensus is wrong, then those positions could very valuable to us. We think the portfolio construction is still the most important thing to be thinking about, and in particular the diversification in portfolios. We do have credit, we do have emerging markets, and against that, we think there's a case to be made to have some interest rate risk in portfolios as well.

MH: Any additional comments for investors and advisors as it relates to the impact and outlook for closed-end funds specifically?

JB: You know, it continues to be a pretty dynamic period. Lots of events going on and a lot of changes. Especially with the economic data having turned somewhat and the optimism that you hear, and combined with the political noise and the underlying risk. It continues to be a very dynamic and volatile time. It's one in which I think diversification benefits you, having a very active approach benefits you. We remain pretty optimistic. I think this is a good time to be in markets, and I think there's a lot of opportunity right now.

You can find more insight from Western Asset on their website at westernasset.com, as well as information about their closed-end funds on the Legg Mason website at leggmason.com. Information is also available on CEFA.com – your comprehensive resource for education, data, and timely insight on closed-end funds.