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Prepare for rising rates: Taking a fresh look at portfolio allocations

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Executive Summary

- We expect the Fed to begin hiking rates in June, but at a slow and moderate pace.
- Fixed-income portfolios should be examined, with an eye toward reallocating recent gains from core fixed income to higher-yielding parts of the universe.
- Rising rates reflect stronger U.S. economic growth, so corporate earnings ought to benefit, but international equities look more attractive.

A long pause

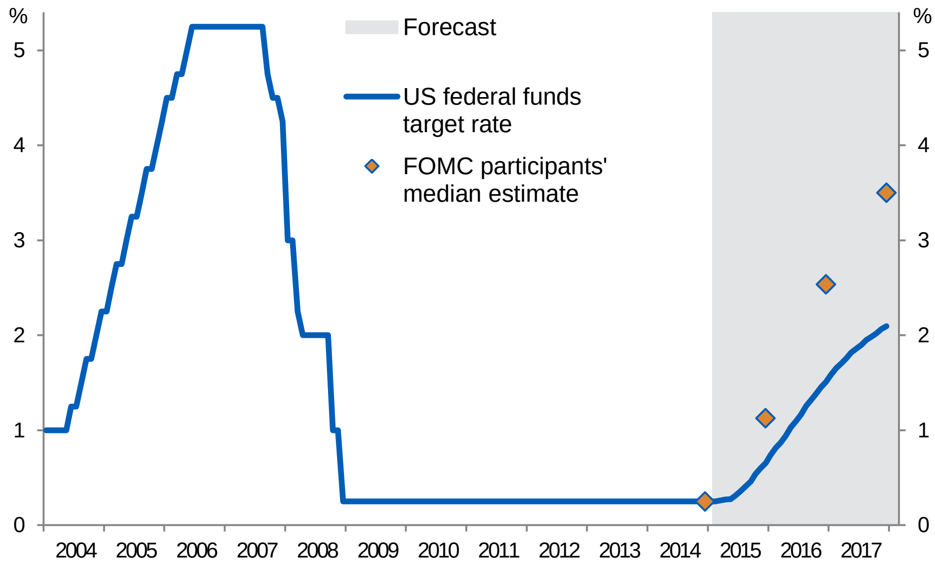
The imminent start of a new tightening cycle by the Federal Reserve has prompted investors to re-examine their portfolio allocations. The U.S. economy has just been through by far the longest period of stimulative monetary policy since President Nixon ended the convertibility of dollars to gold in 1971; the Fed has pegged the federal funds target rate at 0.25% since 2008 and spent $3 trillion on quantitative easing (QE), but now interest rates are at last set to rise (see Figure 1).

The actual timing of the first increase and the subsequent pace will depend on the strength of the U.S. economy, the unemployment rate, and whether wage pressures are increasing. Along with most market observers, we expect the first increase in June, but even then it is likely to be just 25 basis points (bps), and we do not anticipate the target rate will rise by more than 50 bps by the end of the year. By June 2016, we see the fed funds target rate at 1.25% to 1.5%.

Looking at asset class performance during previous tightening cycles may give some insight into how portfolios should be positioned for what will be a very different economic and financial environment. There have been eight periods when the Fed increased interest rates after a period when rates were steady. Any evaluation of the performance of equities and bonds must take into account the broader environment, however. Every cycle was different, so the lessons for today must be interpreted in that light.

TIAA CREF
Financial Services

Figure 1: Fed funds target rate



Data as of 12 March 2015. Sources: Bloomberg, Federal Reserve, TIAA-CREF Asset Management.

The table in figure 2 shows each of the eight periods and several key factors: how much interest rates increased over the 12 months following the first hike; the overall level of inflation; the trend in the inflation rate; and whether bonds and equities were expensive or cheap (based on real yields for bonds and relative multiples for equities).

Returns for fixed income calculated from three months prior to the first hike through one year afterwards were either near zero or negative for every cycle but one, in inflation-adjusted terms. That is, fixed-income returns (based on the Barclays U.S. Aggregate Index) were positive, but less than the headline inflation rate over the same period. The average for all eight cycles was -2.4%. The worst returns tended to correspond with periods when bond valuations were high (as they are today) and/or the increase in rates was large (unlike what we anticipate for the next 15 months).

> Bonds returns were generally unable to keep up with inflation when the Fed was raising rates.

Equities managed to post positive real returns half of the time, averaging out to 1.8%. There is a wide range of scores, however, as the 1986 cycle included Black Monday in October 1987, while the strong gains in 1999 end just a few months before the bursting of the dot-com bubble. The weaker equity returns appear to coincide with times when inflation was running high and the Fed was hiking rates to bring inflation under control. In periods similar to the current environment, when the increase in rates was a reflection of stronger economic growth or when the pace of hikes was measured, equity markets continued to appreciate.

Figure 2: Previous Fed tightening cycles

Year of first hike	Change in fed funds over next 12 months	Core inflation level	Trend in inflation	Bond valuation	Equity valuation	Fixed income return (real)	Equity return (real)
1973	+300bps	High	Rising	High	High	-7.9%	-23.8%
1977	+200	High	Rising	High	Low	-4.9	-1.2
1983	+87	High	Rising	Low	Low	-3.5	-1.4
1986	+88	High	Rising	Low	Fair	1.0	1.0
1988	+300	High	Rising	Low	Low	3.4	20.6
1994	+250	High	Stable	Fair	Fair	-4.7	-0.6
1999	+150	Moderate	Rising	Fair	High	-0.8	13.6
2004	+200	Moderate	Rising	High	High	0.7	6.0
Average						**-2.1%**	**+1.8%**
2015	**100-125bps***	**Moderate**	**Rising**	**High**	**High**		

Data as of 12 March 2015. Note: Shading indicates parallels with current environment. *Forecast. Bond total returns are the Barclays U.S. Aggregate index. Equity total returns are the MSCI USA index through 1978 and Russell 3000 afterwards. Performance of each index is from three months prior to the first interest-rate increase to 12 months afterwards. Sources: New York Federal Reserve, Department of Labor, Barclays, MSCI, Russell, TIAA-CREF Asset Management.

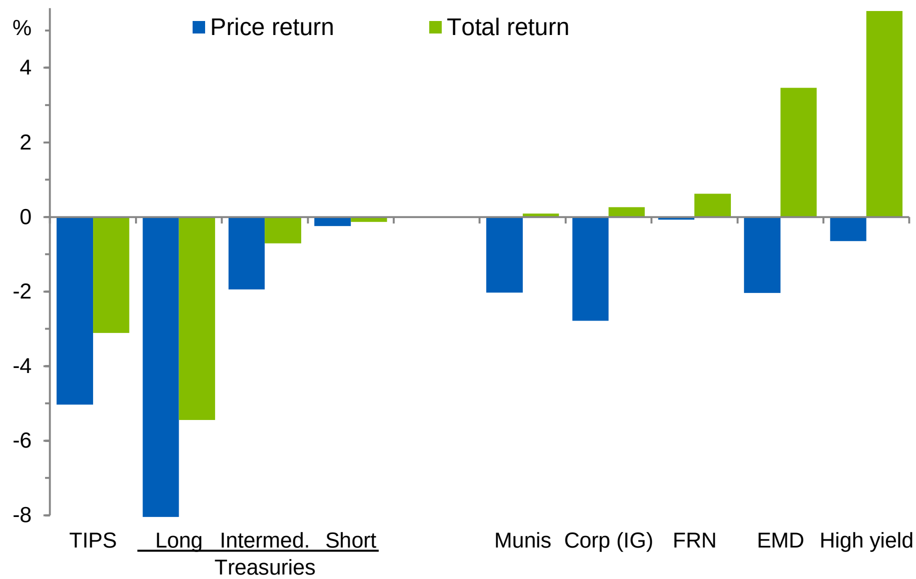
The current environment shares several characteristics with previous cycles.

The environment today of moderate but rising inflation, high bond and equity valuations (for U.S. markets), and a modest pace of interest-rate hikes suggest bonds are likely to post negative returns in aggregate over the next 15 months, while equities should outpace inflation. There are parts of each market, however, that are likely to prove more robust. For fixed-income portfolios, the biggest risk stems from the magnitude of interest-rate increases. The offsetting factor will be the level of income the portfolio generates to offset the decline in bond prices.

That last time that the fed funds target rate was 1.25%—the approximate level we expect it to reach by next summer—was at the end of 2004. Assuming bond yields were to move just 25% of the way from where they are today to where they were in December 2004, we can estimate what would happen to the price of a bond index, and more importantly, what the total return would be after a year once the income is added back.

Figure 3 illustrates this scenario for several types of fixed income. As expected, high-duration assets, such as long-dated Treasury bonds, suffer the greatest decline in price (nearly 8%), and given yields of just 2.6% on the Barclays Long Treasury index, even after a year the total return is still -5.4%. Emerging-market and high-yield debt perform much better, benefiting not only from a boost to the total return from higher coupons, but also lower duration and a smaller gap in yields between current and target levels.

Figure 3: Hypothetical index changes over one year for given increase in rates*



Data as of 12 March 2015. *Assumes rates increase by one-quarter the difference between the current yield on the respective index and average yields in December 2004.
Sources: Barclays, TIAA-CREF Asset Management.

Higher-yielding fixed income generally outperforms when rates are rising.

Looking specifically at how variations of bonds have performed relative to benchmark during the eight tightening cycles, higher-yielding assets again generally outperformed the Barclays U.S. Aggregate Index (see Figure 4). Inflation-protected bonds (TIPS) also outperformed the Aggregate, as inflation rose during the two periods in which they were an investible asset class (1999 and 2004). Corporate, investment-grade bonds only outperformed in three out of eight periods, generally when the duration of the corporate bond index was higher than that of the Treasury index. That is the case today, and spillover demand from Europe for U.S. Treasuries is likely to keep Treasury yields lower than one would otherwise expect, suggesting perhaps another period of underperformance is ahead. Shorter-duration corporate bonds might be the better option.

Figure 4: Outperformance of asset classes during tightening cycles

Asset class	Type	Periods outperforming*	Number of cycles
Fixed income			
	Inflation-protected (TIPS)	100%	2
	Emerging market (USD)	100%	2
	Mortgages	100%	2
	Leveraged loans	100%	3
	High yield	80%	5
	Asset-backed	67%	3
	Treasuries	50%	8
	Municipal	50%	6
	Corporate (investment grade)	38%	8
	Agency	29%	7
	Global (excluding US)	25%	8
	Floating rate notes	0%	1
Equities			
	Global (excluding US)	88%	8
	Emerging markets	75%	4
	Dividends	67%	3
	Value	50%	6
	Growth	50%	6
	Small cap	50%	6
	Mid cap	50%	6
	Large cap	50%	6
	REITS	33%	3
	Preferred stocks	0%	3
Alternative			
	Property	67%	6
	Gold	50%	8

Data as of 12 March 2015. *Percent of tightening cycles the asset class outperformed the benchmark index, Barclays US Aggregate for fixed income, MSCI USA/Russell 3000 for equities and alternative. Performance of each index is relative to benchmark from three months prior to the first interest rate increase to 12 months afterwards. Sources: New York Federal Reserve, Barclays, Credit Suisse, Bank of America Merrill Lynch, J.P. Morgan, MSCI, FTSE, Standard & Poor's, Russell, NCREIF, Bloomberg, TIAA-CREF Asset Management.

We expect international equities to outperform, as they have during previous tightening cycles.

With rising interest rates reflecting stronger economic growth, corporate earnings should continue to rise, though certainly at a slower pace than we have seen over the last few years. The U.S. dollar will also probably continue to strengthen, hampering sales of some multinationals. Given that equity market valuations are well above average in the U.S. relative to most international markets, we would anticipate non-U.S. developed markets and emerging markets will outperform U.S. equities over the next year, as they have during previous periods of Fed tightening. While high dividend-yielding stocks have also generally done relatively well in the past, we suspect they will fail to beat the returns of the broad market this time. This is because the extended period of low yields over the past several years has driven investors not only to higher-yielding fixed income but also to higher-yielding equities. As a result, valuations are very elevated for dividend stocks, and the correction in multiples is likely to offset any pickup in yield.

Conclusion

Ahead of rising rates, investors should carefully consider portfolio allocations.

As we approach a new period of rising interest rates, investors should carefully consider their portfolio allocations. Gains from core fixed income accumulated over the last year might well be reinvested in higher-yielding bonds or in equities, particularly those outside of the U.S. The slow pace of hikes we anticipate suggests that neither fixed income nor equity markets should see sharp corrections, but some parts of each market will certainly do better than others.