Charting a Course to Higher Ground

Understanding the investment implications of rising interest rates

Be prepared.

That time-honored motto of the Boy Scouts may also apply to investors unnerved by a question that's been on their minds for months, if not years.

"Our clients want to know how they should position their portfolios for when short-term interest rates start to rise," said Northern Trust Chief Investment Officer Bob Browne. "The Federal Reserve (Fed) is nearly finished with its bond-buying program, so the final major step in normalizing policy would be to raise benchmark interest rates. While we don't think that step is coming anytime soon, it is good risk management to be prepared for it."

The Fed dropped those benchmark rates to near zero amid the global financial crisis in December 2008. They've remained in a 0% to 0.25% band ever since.

But after struggling through an unusually harsh winter that may have restrained consumer and business spending, the U.S. economy appears to have picked up steam.

The 8.7 million jobs lost during the Great Recession and its dreary aftermath have been reclaimed. Recently, at least 200,000 new jobs were created in each of four consecutive months, the first time that's happened since 2000. Manufacturing also has shown renewed strength.[1]

Revised timetable

The solid rebound from the winter doldrums convinced many economists that the first rate hike will come earlier than previously expected, perhaps in June 2015.[2]

Browne is not among them.

"We think rates are going to stay lower for longer," Browne said. "After having taken such extraordinary steps to nurture a sustainable recovery, there'd be no point in putting it all at risk. We think the Fed will err on the side of caution."

Browne sites stable prices in the United States — and dangerously low inflation

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in Europe and Japan — as providing the credibility the Fed needs to keep policy rates near zero through next year, and perhaps even beyond.

In addition to the lingering hangover from the banking crisis, there's a structural reason for why global central banks have struggled to lift inflation back to their roughly 2% targets: demographics.

In 1950, the median age of the population in developed countries was 28.6 years. By 2000, that number had climbed to 37.4 years, and it is projected to reach 46.4 years by 2050.[3]

"Falling birthrates and increased longevity has skewed the ratio of workers to retirees," Browne said. "A grayer world translates into less demand for goods and services, and potentially less inflation."

Keeping cool

But even if inflation remains subdued, the timetable for raising interest rates could depend on another kind of metric as well.

Browne noted that policymakers are on alert for signs of the speculative fever that triggered the dot-com and housing busts. Historically, long periods of muted volatility — a byproduct of low and stable interest rates — can destabilize the economy and financial markets by encouraging investors to take undue risks.

Or, as Browne put it, "misallocate capital."

But while valuations in the domestic equity and fixed-income markets may be stretched, there is little evidence of careless risk-taking — at least not yet.

"There isn't the same amount of leverage built up in the financial system through poorly understood, non-transparent products like there was in 2007," Browne said. "That may eventually become a legitimate issue, but we don't see it at this time."

Not that the Fed hasn't done its part to push credit into the real economy. Indeed, the central bank's balance sheet has ballooned since the Lehman Brothers bankruptcy in 2008, mostly as a result of three rounds of money printing.

Pushing on a string

Still, Browne said there's a difference between creating bank reserves and inflating the money supply — a widely viewed cause of inflation. That, he noted, requires consumers and businesses to actually take out loans and spend the proceeds, a process that is slowly recovering, though from extremely low levels.

"We don't think that lending activity will increase so sharply from here that the money supply will get out of hand and trigger unacceptable inflation," he said.

Despite his "lower for longer" outlook, Browne said it still makes sense for investors to anticipate a higher-rate world, whenever and however it comes.

He believes the Fed may even employ a "one-and-done" strategy, pushing short-term rates higher by up to a full percentage point all at once, and then call it quits.

Bond market volatility

And what would that do to long-term bond yields?

In that scenario, the fate of longer-duration bonds might depend on how the Fed communicates its intentions and on how investors perceive them. Browne thinks bond yields could spike higher at first — a negative for holders of longer-duration fixed-income assets — but eventually fall back if it became clear that the Fed was not planning to push up short-term rates to pre-crisis levels.

"I don't think we'll return to the typical spread between overnight rates and 30-year bonds any time soon," he said. "We are in a new economic environment, and the Fed appears to recognize that reality."

Yet even if monetary policy remained highly accommodative by historical standards, Browne cautioned against using borrowed money (leverage) to boost returns in a low-yield world.

"When rates do start to ratchet higher, investors who employ leverage probably will be hurt quite badly," he said. "Even if benchmark rates move up later than the consensus believes, it's dangerous to assume they'll stay at these levels forever."

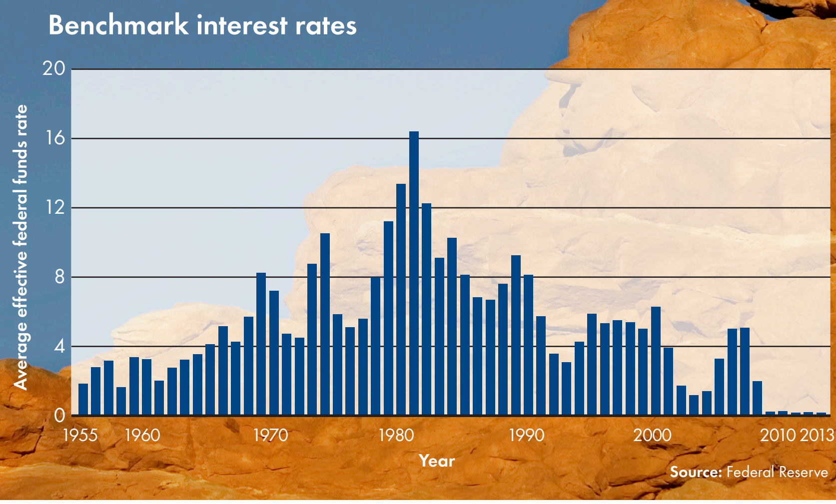
Spreading risk

Given the uncertain environment for monetary policy, Browne advises that investors embrace an "all-weather" portfolio whose stability rests on a three-legged stool: thinking long-term, acting globally, and maintaining broad diversification.

"Keep it simple but diversified," he said. "That may mean adding international stocks to your portfolio, as well as possibly global real estate."

How long can they stay low?

The Federal Reserve pushed benchmark interest rates to historic lows—and has held them at rock-bottom levels for several years. Now, however, investors have begun preparing for the higher short-term interest rates that eventually will come, though perhaps not as soon as many expect.



Importantly, he noted that monetary policy worldwide is not synchronized. In fact, the European Central Bank appears close to taking the same unconventional easing measures that the Fed first employed years ago.

That makes Europe an interesting source of diversification. Though the 18-country eurozone has garnered plenty of negative headlines, Browne said equity-market valuations appear attractive.

Stocks in developing countries, however, are a more complicated subject.

Over the near term, Browne anticipates a potentially bumpy road for emerging markets, especially as U.S. interest rates rise. Looking ahead, though, he said the bullish case for the group remains intact, assuming it is accompanied by realistic expectations regarding the biggest market: China.

"The Chinese economy will not be growing 10% a year anymore," Browne said, "and some investors may take that as a disappointment."

Fortunately, Browne thinks the Chinese government recognizes the risk of hyper-growth in an $8 trillion economy and is willing to live with the consequences.

"A maturing Chinese economy will have business cycles, with growth fluctuating around a roughly 6% long-term rate," he said. "The mass migration from the countryside to the cities was a once-in-a lifetime event, and its impact will wane."

Property values

Real estate, said Browne, is another way for investors to minimize the impact of domestic monetary policy on a portfolio.

While real estate investment trusts, or REITs, often trade like stocks in the short run, over longer periods equity real estate can behave like a separate asset class. Or in the case of global real estate, like several sub-asset classes.

"Owning property through a global portfolio of REITs may be a good way to diversify a portfolio," Browne said. "It can be a potential source of income, and certain subsets of the real estate market also could offer protection if consumer prices do begin to rise."

Rethinking liquidity

Of course, the timing and magnitude of future rate hikes will have a direct impact on cash yields, such as those from traditional money market funds.

But given Browne's forecast that benchmark interest rates will remain lower for longer than is widely believed, he recommends that investors rethink their approach to money that should be kept readily available and conservatively managed.

"Cash has yielded virtually nothing for six-plus years, and if the Fed stays on hold as we expect, it could be at least another one to two years before short-term rates move off the floor," Browne said. "That's a long time to be parking cash at a significant loss relative to inflation."

Rather than employing a single funding source to meet all near-term obligations, Browne said segmenting those requirements into the following three "buckets" could be appropriate for some investors:

- **Transactional.** This category includes money that must remain liquid to meet day-to-day expenses, pay-off credit cards and meet financial obligations that are expected to arise within a few weeks. Money market funds, with their fixed $1 per share net asset values, remain the best vehicle to meet those objectives. "There is no point in giving up the assurance of having all the money there tomorrow to pick up extra yield," Browne said. "Unfortunately, total liquidity comes at a price, especially with rates so low for so long."

- **Operational.** Due dates on bills and outlays here are measured in months rather than weeks. That could provide an opportunity to move at least some money out of cash and into short-term bonds to earn extra income. Though market prices fluctuate inversely to interest rates, fixed-income securities that mature within two to three years typically experience relatively minimal volatility.
- **Strategic.** For money you won't need for the next year, ultra-short-term bonds could be an especially attractive alternative. "It depends on your time horizon and risk profile," Browne said, "but moving money out the yield curve just a little could make sense if there isn't a need for day-to-day liquidity." As of the Fed's last policy meeting in mid-June, two- and three-year Treasury notes yielded 0.48% and 0.95%, respectively. Those rates compared favorable to the 0.03% yield available on one-month Treasury bills.[4]

Running… in place

While Browne thinks it's appropriate for investors to plan for the higher-rate world that eventually will arrive, he believes it could be a mistake to jump the gun.

"We still think we're in a lower-for-longer environment," he said, "and though it is understandable that clients consider what will happen when rates finally rise, it's also important to give equal thought to what happens if rates stay where they are for the next couple of years."

In other words, plan for a higher-rate future, but keep your portfolio firmly rooted in the lower-rate present. N

Past performance is no guarantee of future results.

Neither diversification nor an asset allocation strategy guarantee a profit or protect against a loss.

Bond Risk: Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of rising interest rates.

Equity Risk: Equity securities (stocks) are more volatile and carry more risk than other forms of investments, including investments in high-grade fixed income securities. The net asset value per share of this Fund will fluctuate as the value of the securities in the portfolio changes.

Money Market Risk: *An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency. Although the Fund seeks to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in the Fund.*

Emerging Markets Risk: Emerging market investing is subject to additional economic, political, liquidity and currency risks not associated with more developed countries.

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REIT/Real Estate Risk: Investments in the Fund are subject to the risks related to direct investment in real estate, such as real estate risk, regulatory risks, concentration risk, and diversification risk. Investments in REITs involve certain additional unique risks. By itself the Fund does not constitute a complete investment plan and should be considered a long-term investment for investors who can afford to weather changes in the value of their investments.

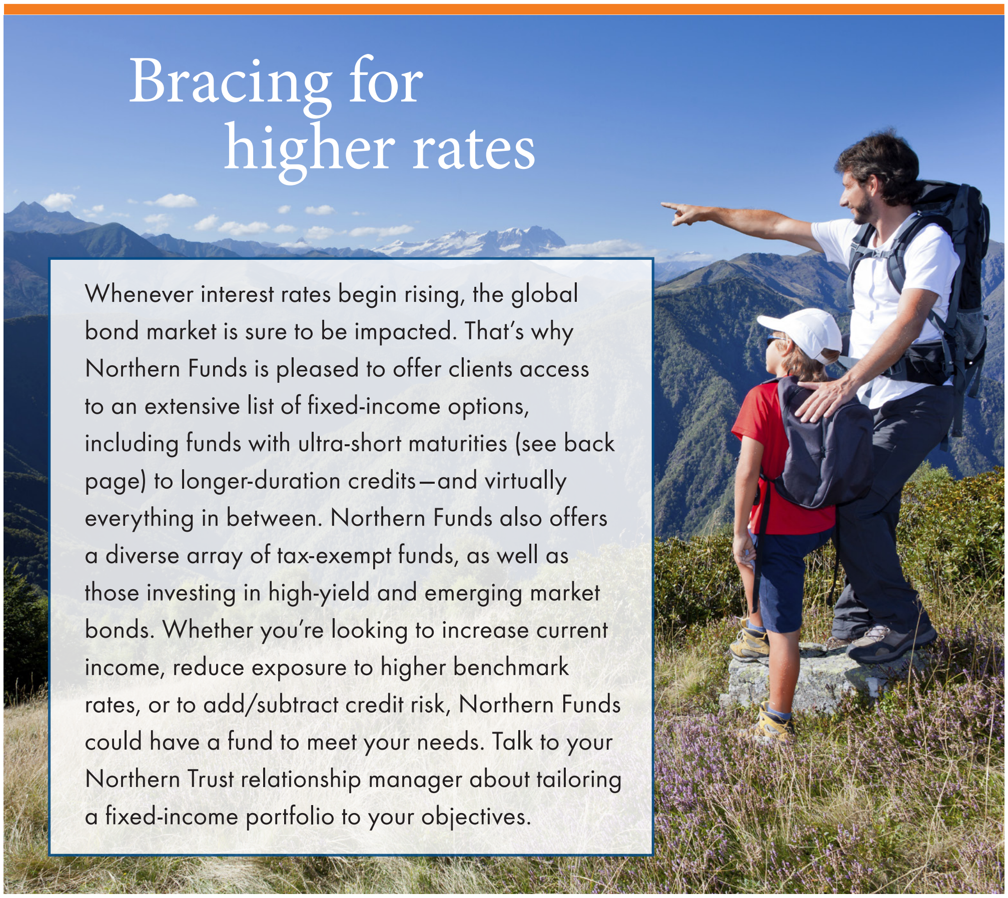
Basis Points (bps) is a unit of measure in quoting yields, changes in yields or differences between yields; 100 basis points is equal to 1%.

[1] "As Jobless Claims Dip, Growth Picks Up Speed." *The New York Times.* June 20, 2014.

[2] "Treasurys Fall on Fear of Rate Increase Sooner Than Expected." Min Zeng. *The Wall Street Journal.* June 14-15, 2015. Page B5.

[3] "Changing Balance Between Age Groups." Population Division, DESA, United Nations. Page 17.

[4] U.S. Department of the Treasury.



Bracing for higher rates

Whenever interest rates begin rising, the global bond market is sure to be impacted. That's why Northern Funds is pleased to offer clients access to an extensive list of fixed-income options, including funds with ultra-short maturities (see back page) to longer-duration credits—and virtually everything in between. Northern Funds also offers a diverse array of tax-exempt funds, as well as those investing in high-yield and emerging market bonds. Whether you're looking to increase current income, reduce exposure to higher benchmark rates, or to add/subtract credit risk, Northern Funds could have a fund to meet your needs. Talk to your Northern Trust relationship manager about tailoring a fixed-income portfolio to your objectives.

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