NAVIGATING THE FIXED INCOME LANDSCAPE WITH WESTERN'S MARK LINDBLOOM

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Professor Siegel and I recently sat down with Mark Lindbloom, Portfolio Manager at Western Asset Management Company (Western Asset), who is part of the team named Morningstar's 2014 Fixed Income Manager of the Year. We discussed a wide range of topics that spanned the recent release of gross domestic product (GDP) figures, Federal Reserve (Fed) policy and his views on fixed income investing, particularly with respect to unconstrained strategies that he oversees at Western Asset. **Schizophrenia—Consistently Strong Jobs Market and Weak GDP** The GDP print of -0.7% in the first quarter of 2015 was better than anticipated. However, Professor Siegel highlighted the risk of U.S. growth missing the overly optimistic Fed target this year, especially given the weak projections for the coming quarters. This could set the stage for a later-than-expected rate hike. Professor Siegel additionally attributed the weak GDP print to the deep-seated productivity collapse. If not for the tanking productivity, the GDP print ought to have been much higher, given the healthy housing market and falling gasoline prices. Mark was generally in agreement and noted that while the Fed is anxious to get off its 0%-bound policy, its future actions are highly data dependent. **Lower for Longer Rates?** Professor Siegel believes that fundamental factors such as slow growth, after-crisis risk aversion, aging baby boomers and the de-risking of pension funds are key factors in keeping rates lower for longer. Not only are we seeing a new normal in terms of GDP growth, where the economy is expected to average 2%, but the aforementioned factors are important considerations for rates in the coming quarters. Siegel estimates that TIPS yields are likely to trade between 1% and 1.5% at its peak. Adding inflation of 2% on top of that, Professor Siegel sees normalized 10-year bond yields between 3% and 3.5%—much lower than historical rate levels. Mark noted that in addition to those factors, there is also a debt overhang around the globe, and the surprising nature of negative yields in many European bond markets. He is generally wary of not having any cushion in yields, particularly if we start seeing improvements in European economic data in the coming months. In the US, Mark's team at Western Asset is positioning itself very tactically with respect to interest rate sensitivity. As an example, it added to duration risk recently when interest rates picked up but had shortened duration earlier this year following the large bond rally in January. **Unconstrained Bond Strategies: A Bond Portfolio Complement** Mark believes unconstrained fixed income strategies are important tools in the present environment. He reminded us that an unconstrained strategy does not imply a lack of process but rather the ability to consider fixed income investing in a systematic and repeatable way. Furthermore, unconstrained strategies offer the opportunity to rid the investor of outmoded benchmarks that allocate weight to where there is the most debt outstanding, but not necessarily where there are the most value opportunities. Mark sees unconstrained strategies as an important complement to traditional core fixed income portfolios. While traditional fixed income portfolios typically have volatilities that range between 3% and 6%, unconstrained strategies are defined by their volatility objectives—which vary depending on the specific manager. While the opportunity set for an unconstrained manager would be the same as the commonly employed benchmarks, the risk budgeting or targeted volatility for rates, yield curve, spread and duration would be different. **Key Under-weights and Over-weights** Mark's team is generally under-weight mortgage-backed securities (MBS) and investment grade (IG) corporates—which he believes are not offering adequate yield compensation today. He is over-weight the high yield sector and emerging markets (EM) because he sees valuations as more attractive. Within EM, Mark favors the sovereigns, where valuations remain depressed. There has been some notable positive performance in EM corporates (USD); thus his team has shifted some weight away from this sector. **Long-Run Fed Funds Projections** The environment of rising rates is inevitable, although Mark qualifies this by stating that when rates start to rise, it will be based upon good things, i.e., meeting growth and inflation targets. This would have the impact of boosting corporate earnings and additionally supporting credit holdings. Furthermore, the pace of rate hikes is likely to be slow, with markets expecting the lift-off to occur in September of this year. The Fed has also been very hawkish on its rates projections. In March it took, for the first time, a step toward market expectations in terms of rate trajectory. This came on the heels of the Fed forecasting substantially higher rates for a prolonged period of time. Professor Siegel agrees that it appears the markets have had a good pulse on economic developments, perhaps more so than the Fed. *Read the conversations with Professor Siegel Series here.*

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DEFINITIONS

Gross domestic product (GDP) : The sum total of all goods and services produced across an economy.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Zero-bound policy rates : central bank policy rates close to the 0% level.

TIPS : Treasury Inflation Protected Securities.

Yield : The income return on an investment. Refers to the interest or dividends received from a security that is typically expressed annually as a percentage of the market or face value.

Inflation : Characterized by rising price levels.

10-year government bond : a debt instrument backed by a government guarantee with an original maturity of 10 years.

Real interest rate : Interest rate accounting for the impact of inflation. From the nominal interest rate, which does not account for the impact of inflation, the rate of inflation is subtracted to get to the real interest rate.

Duration : A measure of a bond's sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Yield curve : Graphical Depiction of interest rates on government bonds, with the current yield on the vertical axis and the years to maturity on the horizontal axis.

Spread : Typically refers to a difference between a measure of yield for one asset class and a measure of yield for either a different subset of that asset class or a different asset class entirely.

Mortgage-backed securities : Fixed income securities that are composed of multiple underlying mortgages.

Investment grade : An investment grade is a rating that signifies a municipal or corporate bond presents a relatively low risk of default.

Sovereign : A national government.

Hawkish : Description used when worries about inflation are the primary concerns in setting monetary policy decisions.