

From Tapering to First Tightening: What's Changed in the Bond Market?

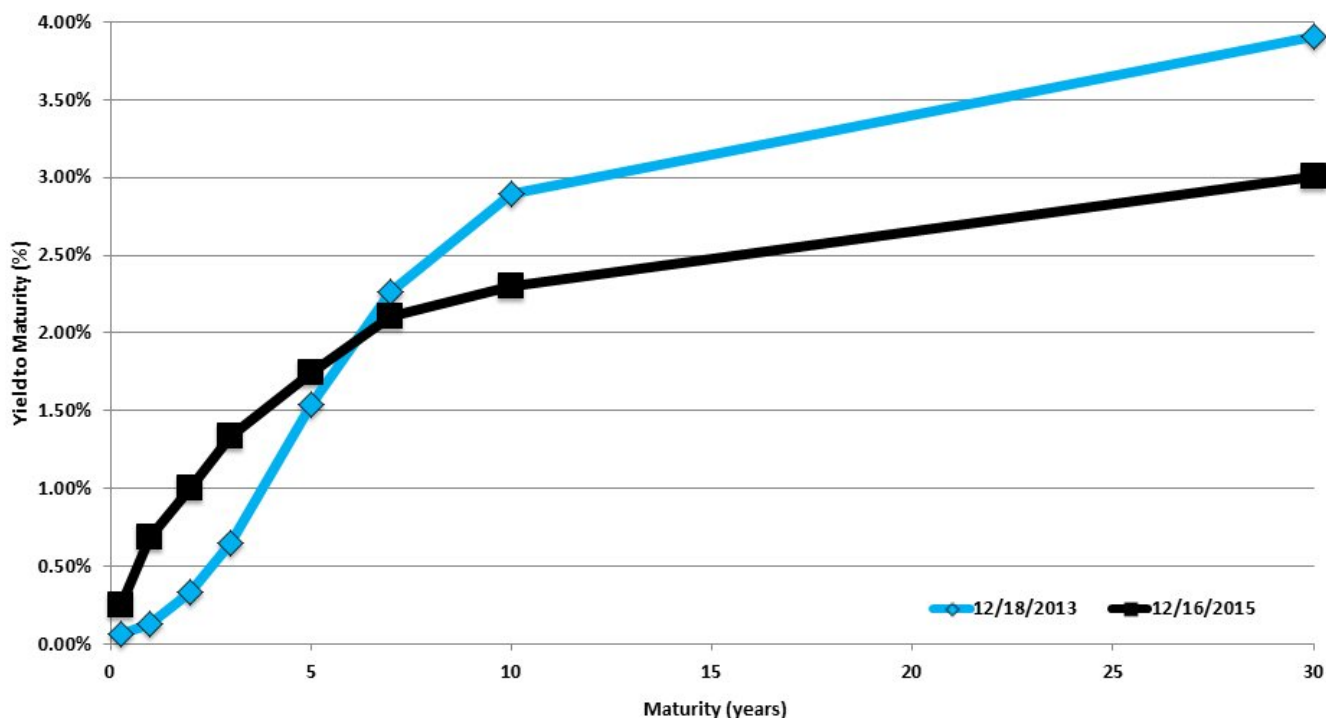
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When the Federal Open Market Committee (FOMC) voted to increase the Federal Funds Rate by 25 basis points (bps) last week, in addition to the first rate hike in more than nine years, this also marked the first unanimous decision by the FOMC since the previous tightening cycle began in 2004. While the vast majority of research commentaries will now shift their focus to 2016, we thought it might be instructive to take a look back. In this piece, we examine how U.S. fixed income has evolved since December 18, 2013, the day the Federal Reserve (Fed) began tapering its bond purchases in an intermediate step to liftoff.

Impact on U.S. Treasuries As we show below, short rates have increased, while longer rates have actually fallen. The result is a flatter yield curve, whereby Fed policy drives up rates to approximately six years and the outlook for global growth and inflation push the long end lower. Looking closer, 2-Year Treasury yields have tripled over the last two years, rising by over 67 bps. Curiously, rates at the 10-year part of the curve actually fell by 60 bps, resulting in a net flattening of 127 bps. Today, economists forecast that 10-year rates could rise to 2.82% by the end of 2016.¹ However, any uptick in growth or inflation could drive rates even higher. In our view, while investors inevitably look to bonds for income, the current trade-off remains extremely unattractive by many historical measures. **Evolution of the U.S. Treasury Yield Curve**



Source: Bloomberg, as of 12/16/2015.

For definitions of terms on the chart, visit our [glossary](#). As we noted last week, investment-grade (IG) credit performed fairly well during the 2004 tightening cycle. Examining the impact on the market since the tapering, the BBB/Baa segment of the market saw credit spreads widen by 62 bps, nearly offsetting the decline in 10-Year Treasuries. In sum, all-in borrowing costs of benchmark issues have not materially changed in the past two years, despite the evolution of Fed policy. Below, in addition to investment grade, we also examine the moves across the various credit ratings buckets of high yield. **U.S. Credit Spreads across Ratings Buckets**

U.S. Corporates	12/18/2013	12/16/2015	Change (bps)
Investment-Grade	118.2	165.2	+47.0
Aaa	59.7	78.2	+18.5
Aa	66.3	86.6	+20.3
A	94	123	+29.0
Baa	156.2	218.2	+62.0
High Yield	414.7	657.3	+242.6
Ba	318	445.9	+127.9
B	383.6	652.2	+268.6
Caa	613.4	1338.3	+724.9
Ca	2021.9	4611.9	+2590.0

Source: Barclays, as of 12/16/15. Past performance is not indicative of future results. Standard & Poor's, Moody's and Fitch study the financial condition of an entity to ascertain its creditworthiness. The credit ratings reflect the rating agency's opinion of the holdings' financial condition and histories. The ratings displayed are based on the highest of each portfolio constituent as currently rated by Standard and Poor's, Moody's, or Fitch. Long-term ratings are generally measured on a scale ranging from AAA (highest) to D (lowest), while short-term ratings are generally measured on a scale ranging from A-1 to C.

With commodities down over 38%² in the last two years, the perceived risk of defaults from borrowers in the Materials and Energy sectors is having a profound impact on the high-yield bond market. With uncertainty surrounding the pace and timing of Fed rate hikes, a general desire to de-risk before the end of the year, and persistent concerns about bond market liquidity, spreads have widened materially in the past several days. Additionally, the restriction of redemptions by one high-yield mutual fund with concentrated positions in the lowest rated, least liquid segment of the market does little to improve investor sentiment/flows. In our view, current depressed valuations do not reflect fundamentals, but absent demand, spreads could continue to languish in the short run. In response to changes at the Fed and a sustained improvement in the economy, we continue to believe that U.S. interest rates will rise over the coming year. While credit has come under pressure, particularly in the highest-yielding segments of the market, we believe that we are nowhere near the end of the current credit cycle. As a result, investors should consider hedging interest rate risk while maintaining exposure to credit as our favored approach to positioning for additional Fed tightening. For investment grade, the Barclays Rate Hedged U.S. Aggregate Bond Index, Zero Duration shows the performance of the Barclays U.S. Aggregate Index with duration hedged to zero years. For greater credit risk, the BofA Merrill Lynch 0-5 Year US high Yield Constrained, Zero Duration Index tracks the returns of non-IG credit hedged to zero years. ¹Source: Bloomberg, as of 12/16/15. ²As proxied by the Bloomberg Commodity Index.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.