Positioning for rising interest rates

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Key Takeaways

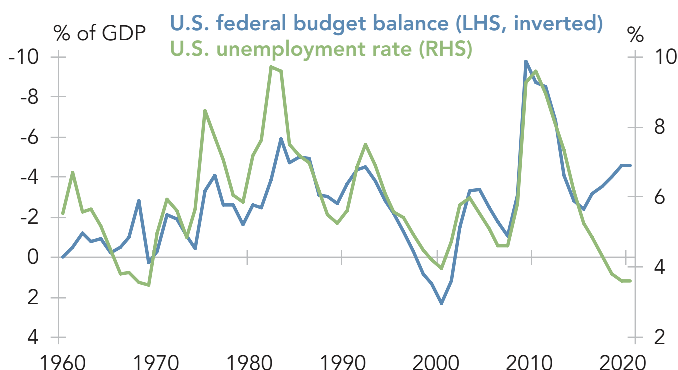
- Interest rates are on the rise
- Active asset allocation can address the challenge
- We are underweighting duration and Canadian assets

As asset allocators, we are increasingly concerned about the prospect for higher interest rates in the U.S. and beyond.

As long-time readers will know, this has not been the case through much of this cycle. As we discussed nearly four years ago in *Don't fear the bond market* and in commentaries since, our general inclination has been to be skeptical of consensus forecasts of a 'normalization' in bond yields, seeing structural factors such as demographics and moribund productivity promoting a 'lower for longer' environment.

EXHIBIT 1: Unprecedented late-cycle fiscal stimulus

U.S. federal budget balance and unemployment rate



Note: 2018–20 projections CBO (budget balance), Fed (unemployment rate).
Sources: U.S. Congressional Budget Office, Bureau of Labor Statistics, Federal Reserve, Haver Analytics, FMR Co.

While those structural restraints are still in place, cyclical and policy pressures on U.S. interest rates in particular are mounting. Unusually, fiscal stimulus is being poured into an economy where the labour market is already the tightest we have seen in decades (see Exhibit 1). Greater protectionism – whether resulting in a full-blown trade war

Our concern over **rising interest rates** has grown, with the 'lower for longer' environment tested by cyclical and policy developments in the United States. This represents a challenge to passive fixed income allocations that we **expect to address** with our active asset allocation process, in particular by **shortening duration** in our funds, **allocating towards higher-income sectors** and making use of the **defensive properties of foreign currencies.**

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or not – will have its greatest impact in making the global trading system less efficient and thus more expensive. Both of these influences risk a greater inflationary impulse than we have seen in many years. In response, the Fed now thinks that even the seven more hikes it projects over the next couple of years may not be sufficient to contain inflation at its target, according to its latest projections. A rising Fed funds rate adds to the impulse of higher interest rates from both the ongoing reduction in the size of the Fed's balance sheet and the increase in government bond issuance to finance the fiscal stimulus.

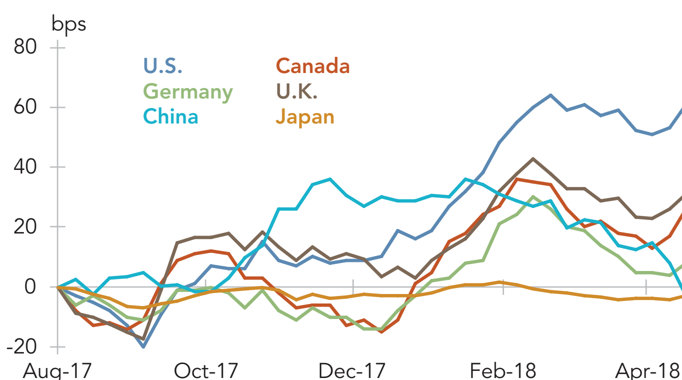
An environment of sustained increases in interest rates, led by the U.S., has three broad implications for our positioning in the Canadian multi-asset class funds.

Underweight duration

First, and most straightforwardly, as asset allocators we have reduced fixed income duration across our funds, where we are now well under the neutral setting in the respective strategies. This is true for our holdings of fixed income in Canada and globally as well, given the extent to which U.S. Treasuries set the tone for interest rates everywhere (see Exhibit 2).

EXHIBIT 2: Treasuries dragging global rates higher

Change in 10-year government bond yields



Sources: National central banks, Tullet Prebon, Haver Analytics, FMR Co.

To be clear, we have not abandoned the fixed income market – bonds still have an important role to play in providing both income and diversification in a balanced strategy. But we do think it prudent to trim the interest rate sensitivity of those holdings, and have done so by underweighting longer-term government and investment grade bonds in favour of shorter-term issues, inflation-protected bonds and higher-income sectors such as floating-rate notes.

Neutral equities

Second, we are remaining cautious on our overall risk posture, maintaining our equity allocations close to the benchmark weight of the respective funds. This is despite the fact that a number of the equity market signals from our four-pillar process have improved somewhat in recent months. The increase in volatility and net decrease in prices since January has led to slightly less expensive equity valuations, while also snapping the market out of what had been increasingly complacent and even euphoric sentiment. In addition, the bottom-up intelligence we get from our equity colleagues has improved further – particularly in the U.S. – with companies reporting cycle highs in earnings visibility and optimism regarding the outlook.

Respecting these signals, we have made small additional allocations to equities across the funds in recent months, primarily in the U.S. But we are unwilling to go further in a macro environment where the long-standing tailwind from ultra-low interest rates looks to be turning into a headwind, both for financial assets and, eventually, the global economy.

Underweight Canada

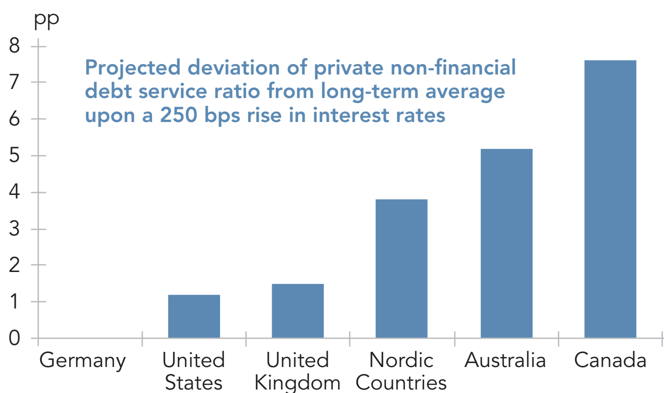
Third, the prospect of higher interest rates has reinforced our conviction in our material underweight to the Canadian market, including from a currency perspective, in two ways.

One, we continue to believe that when it comes to interest rates, where the U.S. goes, Canada cannot follow. This is because of the very different household balance sheet positions in the two countries – while the U.S. has already been through its deleveraging cycle following the Great Recession, Canada's still lies ahead, making the domestic economy significantly more sensitive to any incremental increase in rates (see Exhibit 3). This will mostly likely mean that the Bank of Canada will lag the Fed in withdrawing monetary stimulus ahead, resulting in a widening Canadian rate differential to the U.S., which will tend to push the Canadian dollar lower.

Two, we expect to rely more on the risk management value of the Canada underweight in this environment. As we've discussed many times before, the Canadian dollar is a cyclical currency that tends to be highly correlated with the equities that make up the bulk of the risk in any of our multi-asset class strategies; by underweighting Canada we can take advantage of the fact that overweights to the U.S. dollar, Japanese yen and other 'defensive' foreign currencies will tend to cushion the impact of any drawdowns in the equity market.

EXHIBIT 3: Canada's heightened sensitivity to rates

Debt service ratios in rate shock scenarios, selected countries



Sources: Bank for International Settlements, FMR Co.

The value of this source of downside protection is likely to be increased in a period of rising inflation and interest rates. As we explored in *On 60/40*, such an environment tends to raise the correlation between stocks and bonds, thus making fixed income a less reliable source of downside protection in a balanced strategy.

Active allocation

To sum up, our concern over rising interest rates has grown, with the 'lower for longer' environment tested by cyclical and policy developments in the United States. This represents a challenge to passive fixed income allocations that we expect to address with our active asset allocation process, in particular by shortening duration in our funds, allocating towards higher-income sectors and making use of the defensive properties of foreign currencies. As always, we make these active asset allocation decisions with the goal of maximizing return and managing risk for each fund as a whole.

David Wolf and David Tulk, May 2, 2018

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