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Inflation and Interest Rates — Implications for our clients' portfolios

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A year ago this month, in a white paper entitled "Inflation Consternation," we discussed the ways investors can protect themselves from the eroding effects inflation can have on their investment portfolios. At the time, the debate among economists and investors was fierce and bifurcated, with some predicting Japanese style deflation and others predicting inflation at levels we've never seen here in the U.S. Yet here we are, a year later, with some of the lowest core inflation and interest rates in U.S. history. And the debate rages on.

In this white paper, we discuss our perspective on this global debate. We also discuss the complex relationship between interest rates and inflation to illustrate how history may not be the best way to predict the timing and magnitude of future interest rate changes.

Inflation stagnation

It's no secret why inflation here in the U.S remains below the historical average. Sluggish economic and wage growth, persistently high unemployment and a continued weak housing market are definite inflation busters. Yet, while overall core inflation remains low, the price of food and oil continues to increase, particularly over the last six months as the price of oil has increased over 50%.

Will rising commodity price inflation trickle through the rest of the economy?

Will rising commodity prices create a situation where wages go up, demand for goods and services goes up (out of fear of future price increases), and inflation spirals out of control? **We believe the answer is no.** We believe that this commodity price inflation behaves more like a tax, taking money out of the pockets of consumers of commodities, including companies, governments and individuals, leaving less for discretionary spending and investing for the future. And as you can imagine, this puts further pressure on the economic recovery and could impact stock prices, particularly those of companies who cannot pass along higher costs to their customers.

If inflation were to gain traction and begin impacting a broad basket of goods and services beyond commodities, then stagflation, an economic environment where growth is low and inflation is high, is not out of the question.



A simple look at history would indicate that when interest rates declined to historically low levels, they were generally followed by periods of rate increases, oftentimes negatively impacting bond portfolios.

In investing, as in comedy, timing is everything.

We are primarily concerned with how the current environment will impact our clients' investment portfolios. In addition to our own monitoring of the environment, the active investment managers we recommend to our clients are constantly evaluating how commodity inflation may impact the companies they purchase in their portfolios.

The active investment managers are looking at the fact that some companies are able to absorb commodity price increases by passing along the costs, while others are not. Let's take, for example, the spiraling costs of cotton, which have almost doubled since the middle of last summer. One of our managers has been testing the hypothesis that deep discount retailers selling cotton clothing will lose sales if they increase their prices, or take a hit to profits if they do not. Brand name, higher-end retailers with their less price-sensitive customer base may be able to better pass along their cost increases without losing sales. Both traditional, long-only managers and hedge fund managers are asking similar questions, with the hedge fund managers better able to act on their findings given their broader tool set.

Inflation and its symbiotic sister – interest rates – are inextricably intertwined

Bear with us while we restate the basics. When inflation is low, interest rates tend to be low (in part facilitated by the U.S. Federal Reserve). When rates are low, it's cheaper to borrow. When inflation rises, interest rates generally rise and borrowing becomes more expensive. High interest rates generally deliver a high yield for investors' fixed income vehicles, be they bonds, bank CD's or cash. Rising interest rates, however, can have a detrimental impact on bond prices. Simplistically, as rates go up, already existing bonds with coupons lower than those being offered at the higher rates suddenly become less attractive. After all, why would you want to own a bond delivering a 5% coupon when you can find a new bond delivering a 6% coupon? The demand differential should necessitate a price decline in the older, lower coupon bond.

History is an imperfect guide

A simple look at history would indicate that when interest rates declined to historically low levels, they were generally followed by periods of rate increases, oftentimes negatively impacting bond portfolios. But anytime history is used as a barometer of what might happen in the future, we have to determine if the future will be so different that we cannot simply rely on the past to guide us.

The challenge for investors (and their advisors) is what to do when faced with this dilemma. **We here at Federal Street are actively debating the topic internally.**



Before the fall of 2010, we had already moved to reduce our clients' risks.

We recommended that they move money away from core bonds into more opportunistic fixed income strategies that have additional flexibility to maneuver through the changing interest rate environment.

We are asking ourselves, do rates have to necessarily go up just because they are so low? In investing, as in comedy, timing is everything.

Rates over the past few years have never been this low, indicating that there is more room to move up than down. With every tick down in rates over the last few years, we have become increasingly concerned about the possibility of reversal, some of which we saw late last year as interest rates started to increase.

Defensive strategies for reducing bond investment risk

Because of our belief that rates had more room to move up than down, we saw this asymmetric risk as a reason to make changes to our recommended asset allocation. As such, even before the fall of 2010, we had already moved to reduce our clients' vulnerability to spikes in interest and inflation rates. First, the active bond managers we recommend reduced the duration of their portfolios, thereby reducing the negative impact of rising rates. In addition, we recommended that our clients move a portion of their money away from core bonds into more opportunistic fixed income strategies that have additional flexibility to maneuver through the changing interest rate environment. The benefits of these two strategies kicked into gear at the end of last year as the major core bond benchmarks posted negative returns.

If interest rates have more room to move up than down, why don't we recommend reducing bond exposure even further?

This is where the relationship between bonds and inflation comes into play. The level of interest rates is often thought of as the level at which the market thinks economic growth/inflation will be in the future. Not only are we facing a period of almost record low interest rates, we are also facing a period of low inflation and a wide divergence of expectations for future inflation in different parts of the economy.

Economic growth is low right now here in the U.S. and expectations for growth remain low. This helps explain why rates remain low. Economic growth here would have to be greater than what investors are expecting in order for rates to move higher.

What makes interest rates move?

Again, it's worthwhile to review a few basics. *Short term rates* are generally set by the Federal Reserve and have been close to zero since 2008 in an effort to spur economic growth. The raising of short term interest rates is generally one of the more powerful tools governments use to control inflation.



Structural forces like aging populations, pension plan reform and other factors might indicate that demand for bonds stays high.

We could remain in this low interest rate environment for a very long time, either from these structural changes or from economic forces like low inflation.

Since inflation right now is below where the government would like it to be, and unemployment is so high, we do not anticipate that the government will raise short term interest rates anytime soon. In fact, the government wants to see higher inflation levels but has not been able to make that happen. Despite records amount of government stimulus, companies aren't hiring enough workers, banks are not lending enough money, and/or people aren't borrowing sufficiently to get the economy moving. If the government raised rates right now, they'd curtail growth even further.

Longer term rates are a more complex story

Longer term rates are set by investors through supply and demand. If there are more buyers of bonds than sellers, prices will go up and rates will go down and vice versa. Generally speaking, if investors believe that inflation will increase or that other investors will sell bonds, they, too will sell the bonds, resulting in rates rising and bond prices declining. Without any clear evidence of sustained inflation on the horizon, there has not been enough fear of inflation to drive investors away from the bond market.

New players in the bond market could also be changing the bond market dynamics

There are new players in the bond market who could influence the direction of interest rates in ways other than what history has shown. Foreign governments, particularly China and Japan, have stepped up their ownership and own almost 50% of the outstanding debt of the U.S. Their motivations aren't necessarily clear, with some arguing that their presence in the market provides a stabilizing force to rates while others argue the opposite. The U.S government stepped in after the financial crisis and started their own buying spree by buying bonds in the open market to keep longer term rates low and spur economic growth. (In fact, since November, the Federal Reserve has been buying enough to absorb some three-fifths of new debt offerings issued by the U.S. Treasury.) While this buying program is scheduled to end shortly, it has opened the door to possible future intervention. Finally, structural forces like aging populations, pension plan reform, global currency moves, and other factors might indicate that demand for bonds stays high, and therefore rates could remain low for an extended period of time.

The ultimate demise of the crystal ball

We've never believed that anyone could accurately predict short term moves in the market, but predictions are especially problematic in today's economic environment. While it is safe to assume that rates could move higher at some point in the future, the timing and degree of that movement is unknown, particularly because of the



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structural changes and new entrants into the bond market affecting demand, not to mention recent regional shocks such as turmoil in the Middle East and the natural disasters around Japan. At the same time, it's conceivable that we could remain in this low interest rate environment for a very long time, either from these developments or from an absence of inflation.

So what should our clients do with their bonds?

As you might expect, the answer is specific to each client's situation and the role that bonds play in their portfolio. If our clients sell their bonds, the money will have to go somewhere. If they move to equities, they're subject to the volatility of the equity market and possibly loss of principal. If our client is like most investors in the bond market, s/he is invested in bonds because of a need for a reliable source of income and a safe place in the portfolio to "tap" when funds are needed above and beyond the income generated from the bonds. In this case, equities are not an option.

If, instead, the client sells the bonds and moves to cash or lower maturity bonds, s/he may forgo income, particularly if interest rates stay low or go lower. If rates stay low for an extended period of time, the income opportunity loss from such a move could be large by moving to a lower maturity posture. Given our clients' preferences for "no surprises" in the bond segment of their portfolio, this may be one of many feasible approaches, irrespective of the possible income opportunity loss.

Not a time for cookie cutter investing

Our primary focus here at Federal Street Advisors is to help clients evaluate the alternatives and adopt strategies to achieve their respective rate of return objective without taking undue risk. Since it is not clear when and in what manner interest rates will increase, we are looking even more closely at each of our clients' needs for income, capital preservation, and growth.

The highly uncertain interest rate and economic environment today necessitates intensified, highly individualized portfolio review and planning. This is not a time for a simplistic approach to bond investing.

To explore this discussion more fully, we invite you to contact Kristin Fafard, CFA, Director of Research at Federal Street Advisors.

And please visit our website: www.federalstreet.com