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Insights from Brett Wander

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Perspective on global economic and fixed income markets

Shifting the paradigm: A whole new market

Winter 2018/2019

The end of 2018 was a paradigm shift for investors, heralding in a whole new market environment. The speed of the transformation has left many investors and advisors bewildered, wondering what to make of all the recent changes and how they should inform their investment decisions. In this edition of our fixed income insights, we look at three fundamental adjustments that we believe investors need to consider when thinking about bonds. We also make the case that most of these developments should not lead to extreme asset-allocation realignments.

Shift 1: Wrap your mind around rate cuts

The Federal Reserve has been hiking interest rates for three years, from its first hike in December 2015 to its most recent hike in December 2018. During this time, and even several years running up to it, the dominant conversation in fixed income was the Fed's rate hike timeline. When would the Fed next hike rates? How many more times would the rates rise over the subsequent 12 months? Exactly how high would rates go before the Fed finally stopped?

Around last Thanksgiving, the markets believed that the Fed was ready to raise rates several times in 2019. However, the convergence of the trade war, slowing global growth, and the government shutdown—not to mention a plunging stock market—changed those expectations. It's now quite possible that the Fed is done raising rates this cycle.

Key takeaways

- It's now quite possible that the Fed is done raising short-term interest rates for this cycle.
- We should routinely expect flat and sometimes inverted curves as the economy goes through its natural phases.
- Treasuries and other high-quality government bonds are different from high-yield bonds.
- Risks have changed, and we think this reinforces allocations toward higher-quality holdings.

> Around last Thanksgiving, the markets believed that the Fed was ready to raise rates several times in 2019. It's now quite possible that the Fed is done raising rates.

Exhibit 1 demonstrates how expectations have changed, showing that the markets now expect zero rate hikes this year. However, this doesn't mean that the probability of a rate hike or cut is zero, it means that the probability is just about the same right now.

In essence, the range of outcomes has expanded, and the breadth of this range is one way of measuring risks in the investment environment. A wider range of possibilities reflects higher risks and greater uncertainty. Your clients would do well to remember that in a higher-risk environment, high-yield bonds have the potential to underperform, while high-quality bonds could benefit from demand of those looking for a perceived safe haven.

Shift 2: Flat yield curves should be expected

As the media seems fond of mentioning, the yield curve just seems to keep getting flatter and now seems on the brink of a potential inversion. Investors often interpret this to mean that a recession is imminent. However, it is important for your clients to understand that this is nothing new. In fact, a yield curve inversion is often part of a normal business cycle. We should routinely expect flat and sometimes inverted curves as the economy goes through its natural phases of growth and contraction.

Rather than overreact to the possibility of a normal recession, it's important to be wary of two events that are far more impactful: a sudden, unexpected recession and a severe recession. These are the scenarios that should give investors true pause. The last recession was clearly a severe one. Yet history demonstrates that the end of a business cycle and start of a new one is often a fairly mild market transition. Furthermore, investors would be wise to remember that recessions don't necessarily translate into negative equity market returns. So make sure that your clients avoid unwise allocation changes based on recession fears.

Shifting expectations

The chart shows the change in federal funds rate futures over time, reflecting diminished expectations for interest rate hikes by the Fed this year.

Exhibit 1: Falling rate hike expectations

After the paradigm shift in expectations last Thanksgiving, expectations for rate hikes in 2019 have fallen.

Short-term Fed rate hikes/cuts expected in 2019

Sources: Charles Schwab Investment Management; Bloomberg. Daily data from October 31, 2018 to February 6, 2019.

> The paradigm shift at the end of last year locked in a new reality: We're back to a more volatile, typical market environment.

Shift 3: Higher volatility is back to normal

The S&P 500® Index generated 12 consecutive months of positive returns during 2017, reflecting a profound lack of volatility. After a Goldilocks 2017, we spent 2018 facing bouts of volatility. However, the paradigm shift at the end of last year locked in a new reality: We're back to a more volatile, typical market environment. Exhibit 2 demonstrates this point, showing the cumulative total return of the S&P 500 Index during 2017 compared with 2018, representing two hugely different market environments.

There is somewhat of a silver lining to the increased market volatility. As we see it, the outlook is always uncertain. However, in higher-risk environments, your clients are more keenly aware of the relative risks and far less likely to be too complacent. We think this is a much more realistic state of mind from which to make investment decisions.

A higher-risk environment also calls attention to an important fact that is usually downplayed during bullish equity market periods like 2016 and 2017—that Treasuries and other high-quality government bonds are different from high-yield bonds. In good times, these securities may all look about the same, but during equity market selloffs, high-quality and low-quality bonds usually perform very differently.

Volatile periods are when your clients' asset allocations are put to the test. If your clients have been uncomfortable with their level of underperformance, they've probably been taking on too much risk. Remember that government bonds and high-yield bonds play different roles in a portfolio.

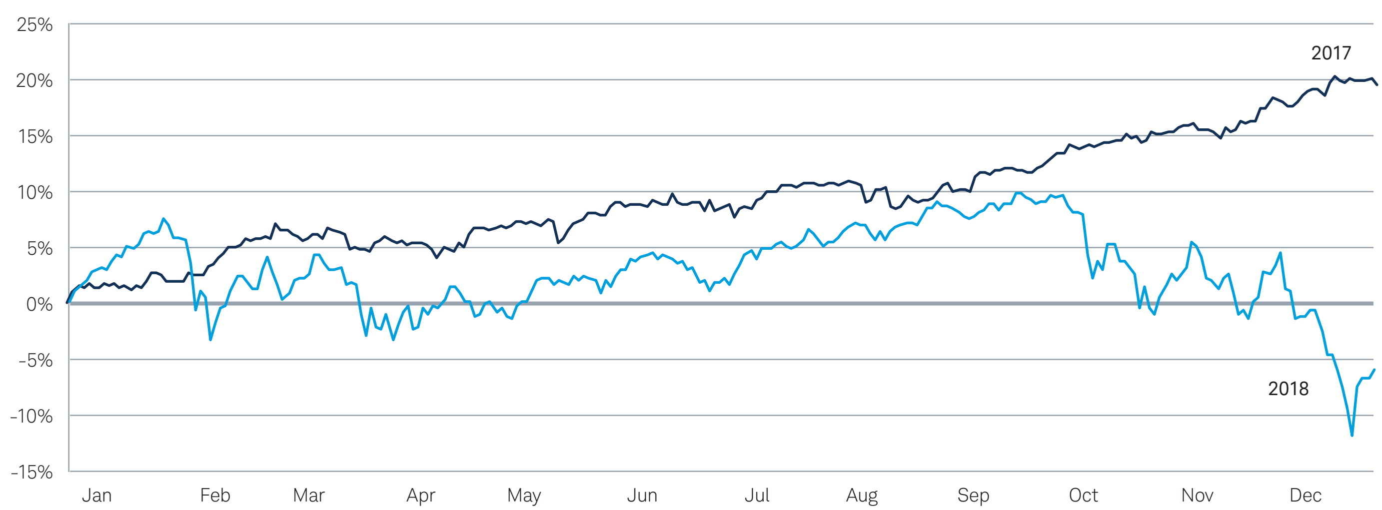
The Trump factor

As we embrace this new environment, we must also address the unrelenting background noise—the political fights, sudden tweets by President Trump, trade war talks, and other drama that periodically flares up, both domestically and internationally.

The noise has been with us for a few years now, and the markets have become increasingly accustomed and somewhat desensitized. However, in the recent past, the noise coexisted with a positive backdrop of tax cuts and robust U.S. earnings growth. In this combination, company fundamentals far outweighed the daily ups and downs of headlines. But now, things are different: The length of the government shutdown, and the severity of the trade war impart risks that may seem daunting.

Exhibit 2: Normal volatility has returned to equity markets

S&P 500 return - 2017 vs. 2018



Sources: Charles Schwab Investment Management; Bloomberg. Cumulative total returns, compounded daily.

This is a good reminder that markets have a way of sizing up the potential impact of a headline on corporate activity. A major political event may ultimately have very little effect on the economy, irrespective of how frequently it appears in the headlines. This isn't to say that domestic and geopolitical events don't matter, just that many of them are investment noise, and the markets will likely adjust accordingly.

A silver lining

The tectonic shift in the investment environment may look quite negative at first blush, but we see a silver lining. Risks have changed, and we think this reinforces allocations toward higher-quality holdings. Still, none of these developments qualify as unexpected or severe, which means they are a normal course for markets and for investors.

The changes are also an excellent reminder of why fixed income is critical: for ballast when a portfolio needs it the most. For your clients who struggle with the recently elevated volatility and uncertainty, a more fundamental review of asset allocations is in order, with a focus on quality. Help your clients see why overreacting and reallocating assets based on recession fears can sabotage their long-term financial goals. Make sure your clients understand that high-quality securities like Treasuries are quite different from high-yield bonds and that they should be viewed as distinct asset classes with differing risk characteristics.

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About the author

Brett Wander is Chief Investment Officer (Fixed Income) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Wander joined CSIM in 2011 and is responsible for all aspects of the firm's fixed income and money market portfolios, leading a team of more than a dozen investment professionals. Over his more than 20 years of investment management experience, Wander has been intimately involved in the design, development, and oversight of a wide range of active, indexed, and alternative fixed income strategies. His expertise spans a wide range of global and domestic markets and sectors. He is a frequent industry speaker, presenting at conferences and in various media forums. He has taught MBA-level investment courses at the University of Southern California. Wander earned an MBA from the University of Chicago and a BS in system science engineering from the University of California, Los Angeles. He is a Chartered Financial Analyst® charterholder.

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