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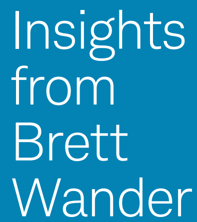


Insights from Brett Wander

Chief Investment Officer, Fixed Income

Perspective on global economic and fixed income developments

Don’t ditch your bonds

December 2016

If the major events of 2016 teach us anything, it’s to expect the unexpected. From “Brexit” to Trump’s victory, 2016 provided an abundance of surprises. Perhaps the most counterintuitive event of this year was the market’s unexpected response to Trump’s victory. Bond yields rose dramatically after the election results became clear and stocks rallied hugely, the exact opposite of what was expected. However, it may be foolhardy to assume that 2017 will play out as an extension of the interest rate environment that we faced in the days and weeks immediately following Election Day. With this in mind, we provide five investment considerations for the New Year, emphasizing wholeheartedly that investors shouldn’t ditch their bonds based on the recent “Trumpian” effect.

Expect the unexpected

Brexit passed and Trump won. Based on financial market reactions, investors were quite surprised by both results. Yet by some estimates leading up to these “unexpected” outcomes, they represented an approximately one-in-four likelihood, making them hardly inconceivable. Some investors tend to treat unlikely events as quite shocking when they occur, which has important investment implications. Looking toward 2017, the interest rate environment is shaping up to be one of significant uncertainty, with the political and economic landscape rarely this volatile. This means that a balanced investment approach that includes an allocation to fixed income securities could prove important in the New Year.

Key takeaways:

- Assuming that the 2017 interest rate environment will play out as an extension of what we have recently faced may be foolhardy.
- A common misconception over the past half-decade has been that bond yields could only go up; *surprise, this didn’t happen!*
- We continue to believe that bond yields could stay low for longer than previously anticipated.
- Replacing higher-quality bonds with higher-yielding bonds can potentially hurt a portfolio’s long-term performance.
- Selling fixed income securities based on the recent “Trumpian” effect could result in taking on additional risk at the wrong time.

Don’t over-extrapolate

Are rates set to rise dramatically in 2017? We think that the interest rate environment around this time next year may surprise investors. Immediately following Election Day, bond yields rose dramatically, triggering waves of fear regarding where U.S. rates may be headed in 2017. Increased uncertainty is an unavoidable part of our near-term outlook, but over-extrapolating this initial reaction into a longer-term investment plan could prove costly.

As shown in the chart below, 10-year Treasury yields at about 2.40% in early December are close to where they were at the start of the year. This may seem surprising in light of the bond market’s recent reaction. After all, rather than a significant flight-to-quality that was expected if Trump won, yields instead rose as soon as the election results became clear. This reflected renewed expectations for economic growth and inflation.

Use a telescope, not a microscope

What does all this mean for fixed income investing in 2017? It’s important to appreciate that there’s a significant difference between short- and long-term rates. The Fed influences short-term rates through its policy decisions, but its ability to affect longer-term rates is quite nebulous. It’s even possible for longer-term rates to fall when the Fed raises short-term rates, as was the case last year. Remember, inflation and growth expectations are the primary drivers of longer-term rates.

Ditching fixed income securities based on the recent “Trumpian” effect could result in a portfolio taking on additional risk at an inopportune time.

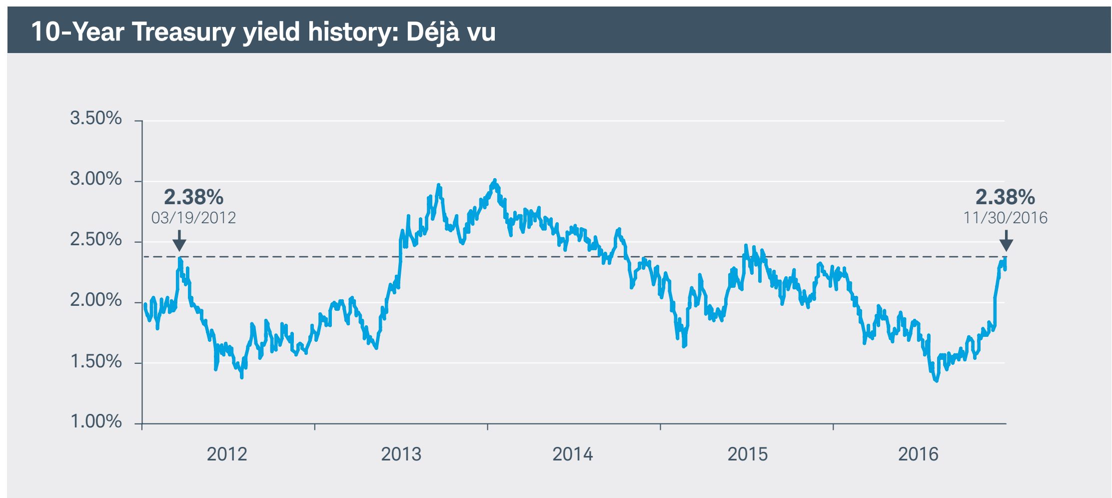
Moreover, although U.S. inflation pressures may be starting to emerge, a variety of international factors could help to keep these forces in check. Add to this the relative attractiveness of U.S. Treasuries compared with international government bonds, and our conclusion is that near-term increases in U.S. rates may be limited. In other words, don’t bet that the recent jump in bond yields will continue along the same trajectory into 2017, and don’t bet on inflation skyrocketing anytime soon, either. So ditching fixed income securities based on the recent “Trumpian” effect could result in a portfolio taking on additional risk at an inopportune time.

The chart below illustrates that 10-year Treasury yields are not only near where they started this year, but they’re also not that far from where they were back in early 2012. *A common misconception over the past half-decade was that bond yields could only go up; surprise!*

Surprising yield history

A common misconception over the past half-decade was that bond yields had nowhere to go but up.

10-Year Treasury yield history: Déjà vu



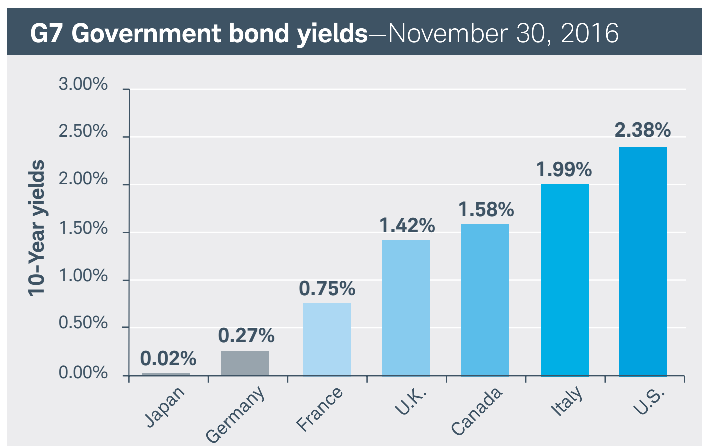
Source: Bloomberg; 10-year Treasury yield data from 2012 through November 30, 2016.

Talk is cheap

The recent selloff in bonds is predicated on President-Elect Trump's ability to do three things: (1) cut taxes, (2) increase U.S. spending, and (3) decrease regulation. The combination of all three would likely increase economic growth, the U.S. budget deficit, and inflation, which would drive up yields. However, the big question is whether Trump can deliver. Even with a Republican majority in both the House and the Senate, it's tough to get things done in Washington. So the "inevitable" increase in inflation is actually far from a foregone conclusion. After all, history teaches us that talk is cheap when it comes to politicians and their campaign promises.

Focus on the fundamentals

For U.S. rates to rise well above late-2016 levels, actual inflation—not merely forecasted inflation—would need to rise. We would need to see a notable upswing in gauges like the consumer price index and the personal consumption expenditures index, along with wage increases. The U.S. remains a relative bright spot among developed economies, but overall, even U.S. growth is far less than robust. If U.S. inflation stays contained, any increase in rates could be limited. Also, don't forget that G7 government bond yields are generally well below those of U.S. Treasuries, as reflected in the following chart.



Source: Bloomberg; 10-year maturity, generic government bond yields as of November 30, 2016, in local currencies.

Further increases in U.S. rates would likely drive up international demand for U.S. bonds, anchoring Treasury yields, and by extension, the broader U.S. bond market.

This brings us to the Fed's final policy meeting of 2016. If federal funds futures are any indication, a rate hike is all but guaranteed. What is clouded is how quickly the Fed will actually move to further "normalize" rates in 2017.

As we closed out 2015, the Fed forecasted four rate hikes for the following year, and we may hear a similar story at 2016's final meeting. The Fed won't outline specifics, but we think that they will probably intimate that 2017 could see several rate increases. It's unclear to what degree the market will reflect similar expectations. More importantly, even if the Fed continues moving toward policy normalization, that doesn't necessarily mean longer-term bond yields will increase correspondingly.

Reaching for higher yields amid volatile market conditions can set up a portfolio for periods of unexpected under-performance, especially if doing so would involve switching out Treasuries for high-yield corporate bonds.

Key takeaways

So what are the key takeaways? Namely, that maintaining a well-diversified portfolio that includes an allocation to U.S. fixed income securities could be particularly important in 2017. These investments provide diversification benefits that can help balance the equity portion of a portfolio, particularly when financial markets confront events that drive up safe-haven demand. Moreover, we continue to believe that bond yields could stay low for much longer than previously anticipated, and we think this is particularly true for U.S. Treasuries. After all, the obstacles for Trump are formidable, and achieving his three primary objectives is anything but guaranteed.

Investors would also be wise to resist the temptation to overreact to short-term volatility, and to avoid overreaching for yield. Reaching for higher yields amid volatile market conditions can set up a portfolio for periods of unexpected underperformance, especially if doing so would involve switching out Treasuries for high-yield corporate bonds. Such an approach could reduce the potential diversification benefits of the fixed income slice of a portfolio. So don't ditch your bonds simply because of the recent Trumpian effect.

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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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