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GLOBAL INSIGHT

SPECIAL REPORT

Countdown to Liftoff

Prudent fixed income positioning as the Federal Reserve debates initiating the launch sequence on the next tightening cycle

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Special Report

Countdown to Liftoff

Fixed Income Positioning Ahead of Rate Hikes

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With the Federal Reserve potentially getting ready to turn the ignition key on its long-awaited rate hike, now's the time for fixed income investors to get their portfolios ready for liftoff. While the timing of a rate hike remains uncertain, the inevitability of one is not, in our opinion.

A string of solid economic data has raised the likelihood of an interest rate hike by the Federal Reserve in the coming months. The Fed looks set to embark on the next step toward normalization of monetary policy by raising short-term interest rates, which we feel warrants a portfolio review by investors this summer. A natural inclination for investors may be to shorten their duration profile in a rising rate environment, but we feel too much defense can be a bad thing.

The rate hike process will likely be long and drawn out, but it is also inevitable, in our view. By developing a balanced approach within fixed income portfolios, and understanding where the potential risks and rewards lie, investors can still build prudent portfolios, even in a rising rate environment.

Down the Home Stretch

Fixed income investors are right to have concerns about their current portfolios heading into a tightening cycle, although we still expect the interest rate normalization process to be a long and slow journey over the next few years. This article will put some context around a "rising yield environment" and put forth some best ideas and strategies to what are likely to be common questions from many investors, including:

- **Yield Curve Positioning:** How fast, and by how much, might yields rise and how should portfolios be positioned?
- **Sector Positioning:** What options are available, what type of risks will an investor be exposed to, and where are the best values at the moment?
- **Portfolio Strategy:** When everything is put together, what are some strategies to think about when trying to balance current income needs against achieving positive total returns over a certain investment horizon?

Since 1976, nearly 93% of the total return in the Barclays U.S. Aggregate has come from coupons, rather than from bond price appreciation. We believe this should form the basis for thinking about fixed income at this juncture, as income from portfolio holdings should offset any modest declines in bond prices that occur amidst an extended and gradual adjustment period toward higher yields.

Curve Positioning

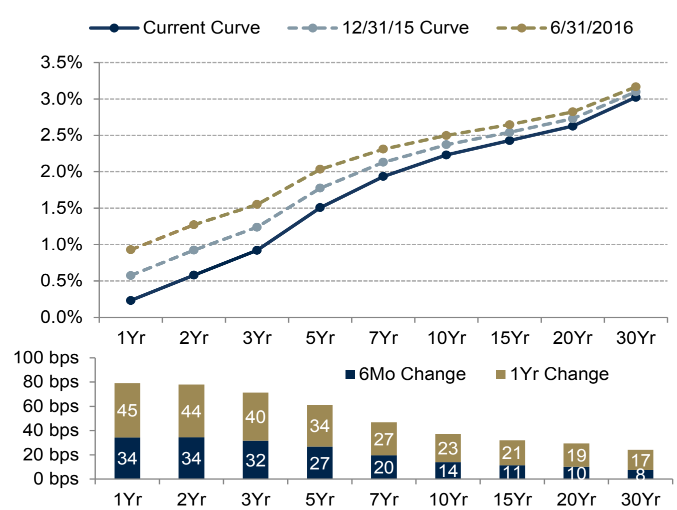
The first step when assessing a fixed income portfolio is to form a view on the outlook for yields.

In our opinion, the yield curve will gradually flatten. That is, short-term yields will rise faster than longer-term yields. As the chart illustrates, this is also what the market is currently expecting, with yields on the 2-year Treasury estimated to rise 40 basis points (bps) by the end of the year, while the 10-year may increase only an additional 12 bps. The same holds true for one year from now.

However, this flattening trend should play out over years, in our view, while the curve still remains steep from a historical perspective.

We believe focusing on the steepest part of the curve and balancing this against available yields is arguably the most important factor to consider. *In this respect, we think the 5- to 8-year part of the curve currently offers the best risk/reward profile, as the gains from "rolling down the curve" are the greatest, with the price volatility from higher yields relatively low.*

Visualizing a Flattening Yield Curve



Source - RBC Wealth Management, Bloomberg; Data as of 7/7/15

Short-term yields are anticipated to rise faster than long-term yields.

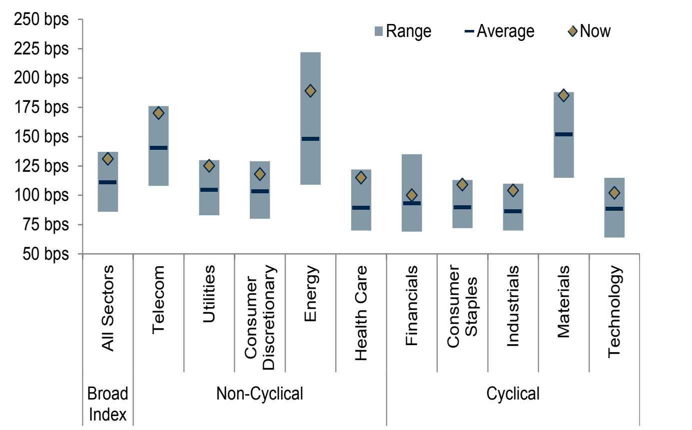
Create a Balanced Risk Profile

The next step is to form an outlook for the various fixed income product classes.

- **Corporate Bonds:** Investment-grade corporates have underperformed this year amid the global government bond market selloff. The chart on the next page shows how spreads for most sectors are at the highest levels since the beginning of 2013.

  Fortunately, wide spreads at the beginning of a tightening cycle offer significant cushion against rising yields. *We continue to favor "BBB"-rated credits at the low-end of the investment-grade spectrum as they offer the best mix of reduced interest rate risk and increased economic growth exposure.*

Investment-grade Sector Spreads Over Treasuries Since 1/1/13



Source - RBC Wealth Management, Bloomberg; Data as of 7/6/15

Spreads for most sectors look attractive at levels not seen since the June 2013 "taper tantrum."

We would advise caution on the high-yield sector into year-end, and ahead of the first rate hike, given its heightened sensitivity to Fed policy expectations.

- **Preferred Shares:** Our view is that securities featuring fixed-to-floating dividends should outperform fixed-dividend preferreds, as fixed-to-floaters' duration is limited to their fixed-dividend period and could eventually benefit from a higher and flatter term structure in the future, while generating high current income.

- **Municipal Bonds:** Though tax-exempt munis benefit from only moderate sensitivity to Treasury yields, that also means they haven't participated to the same extent as other products in the recent selloff, leaving valuations at relatively rich levels. Nonetheless, for investors in higher tax brackets, munis offer competitive returns with comparable taxable issues. We still think that short-call, high-coupon structures around 2017–2021 will work over the near term as cash-like alternatives. Currently, however, we believe muni investors can find the best values further out on the curve.

Put It All Together

The last step is to put it all together to develop a strategic approach. But first we think it is important to have some historical perspective.

The chart on the next page highlights that market performance months after the first rate hike in 2004 was actually positive. One possible explanation for this is that investors had priced in hikes too aggressively going into the hiking cycle. As the cycle got underway, investors recalibrated their expectations for the pace of future hikes and the eventual peak rate at which the Fed would move to a neutral stance.

Given that rate hike-related uncertainty has been high in recent months, we wouldn't be surprised to see a similar reaction this time around. The negative bond market performance of recent months could set the stage for a potential, albeit modest, rebound.

Rising yields do not necessarily portend negative total returns.

Fixed Income in Perspective

	2015 Statistics			2004 Performance		Price Sensitivity	
	YTD Performance	Duration (Years)	Yield to Worst	3 Months Prior to First Rate Hike	6 Months After First Rate Hike	Interest Rates	Economic Activity
Fixed Income Market							
Barclays Aggregate	-0.73%	5.67	2.36%	-2.44%	+4.18%	Medium	Medium
Taxable Bonds							
Investment-Grade Corporate							
Barclays 1-3Yr U.S. Corp.	+0.76%	1.93	1.65%	-1.15%	+1.58%	Low	Medium
Barclays U.S. Corp.	-1.58%	7.01	3.31%	-3.42%	+5.66%	Medium	Medium
Barclays Baa Corp.	-1.12%	7.51	3.90%	-3.20%	+6.50%	Medium	Medium
High-Yield Corporate							
Barclays U.S. High Yield	+2.94%	4.28	6.60%	-0.96%	+9.64%	Low	High
S&P U.S. Preferred Stock Index	-0.01%	-	-	-4.76%	+10.41%	High	Medium
Tax Exempt							
Barclays Municipal Aggregate	-0.12%	6.73	2.36% *TEY: 3.63%*	-2.37%	+5.19%	Medium	Medium

Source - RBC Wealth Management, Barclays Indices, Bloomberg; Data as of 7/7/15. Performance data calculated from 3/31/04 to 6/30/04; and from 6/30/04 to 12/31/04. Tax Equivalent Yield based on 35% tax rate.

We still think that a "laddered" profile makes the most sense in a rising rate environment. For example, structuring at regular intervals from two to 10 years would produce a steady stream of maturing bonds to then reinvest at what should be modestly higher yields.

For more risk-oriented investors, another strategy would be to concentrate high-yield corporate credits at the front-end of a ladder, where one can benefit from high income and low default risk against a backdrop where we see further economic expansion in the years ahead. This can then be balanced with investment-grade securities at the back of the portfolio, creating a structure that has only limited interest rate risk, high income, and low credit risk—perhaps an attractive risk/reward profile for certain investors.

Finally, in a rising rate environment the key is to match bond maturities with investment goals and objectives. If one has a short-term investment horizon, but the portfolio is allocated to long-term bonds for the extra income, then the investor may be forced to sell at a price below par.

When it gets down to it, positioning matters.

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Sell [Underperform]	117	6.65	6	5.13

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