Fidelity's Perspective on Rising Interest Rates

Fidelity investment leaders discuss the economic and asset allocation implications of higher interest rates in 2017.

Key Takeaways

- U.S. interest rates have fallen to record lows over the past three decades, weighed down by aging demographics, historically low inflation, rising globalization, and other forces.
- More recently, global growth and inflation have accelerated based partly on China's improved outlook, higher commodity prices, and tighter U.S. labor markets.
- The incoming administration's policy outlook is highly uncertain, but its economic agenda could boost growth—and inflation—in 2017, either of which puts upward pressure on rates.
- Fidelity's forecast for 2017 is that rates will remain low relative to their history, but they should trend higher than they are today.
- Historically, shortening duration, real return exposure (TIPS, floating-rate bonds, real estate, commodities), and actively managed equities have been effective strategies in a rising-rate environment.

Fidelity senior investment leaders recently met to discuss the global interest rate backdrop, the outlook for rate policy in 2017, and the asset allocation implications of rising rates. This paper summarizes the key highlights of that discussion.

Interest rates: Higher, but still historically low

For the past three decades, interest rates in the U.S. have steadily declined. Many secular forces have contributed to their fall, including aging demographics and the move from high to low inflation rates. Rising globalization has contributed to the disinflationary environment, as global supply chains, the free-flow of trade across borders, and the ability to access labor around the world have driven down the cost of goods. Technology also has helped to suppress inflation. In recent years, the secular forces that pushed down bond yields were amplified by cyclical factors, including weak global growth, plunging commodity prices, and extreme central-bank policies, including quantitative easing and negative interest rates.

In the first half of 2016, stretching from the market turmoil in January to the Brexit vote in June, assets appeared to be pricing in a worst-case scenario. Universal pessimism about growth, extremely low inflation expectations, extraordinary easing stances from central banks around the world, and strong demand for U.S. government bonds drove Treasury yields to all-time lows.

However, the underlying trends of the global economy and inflation were already accelerating. China's economy, a focal point of global volatility, began to improve. The trade and industrial recessions of late 2015 were on the wane, industrial production was recovering, commodity prices were climbing, and U.S. wages were accelerating as labor markets tightened. Starting around mid-year, a turnaround began to take hold as markets recognized these developments. S&P 500® earnings also rose about 3% in Q3 after six consecutive quarterly declines. These signals of economic improvement, along with indications of rising inflation pressures and a shift in Treasury supply/demand dynamics (Exhibit 1), drove rates higher.

Signs that the U.S. economy is nearing full employment, combined with higher inflation and an improving global macroeconomic backdrop, gave the Fed the ammunition it needed to implement a 0.25% increase in the federal funds rate, to a range of 0.50% to 0.75%. The Fed also reported it expected to raise rates three times in 2017.

Rate hike forecast for 2017

The strength of the U.S. economy and inflation will likely dictate where rates go from here. Inflationary pressures, including higher wage growth, continue to build. And with a new president about to take office, it is difficult to predict how future policy decisions may influence the economy, especially with some disparity between Trump's priorities and those of the GOP Congress (Exhibit 2). It seems reasonable that some aspects of the growth agenda are likely to be implemented and could boost cyclical growth during 2017. However, it is also possible the impact might be partially offset by a greater-than-expected protectionist tone in the policy mix.

In that context, here are two likely scenarios for the U.S. economy and interest rates in 2017:

EXHIBIT 1: Many of the conditions that had driven rates to historic lows are now reversing course.

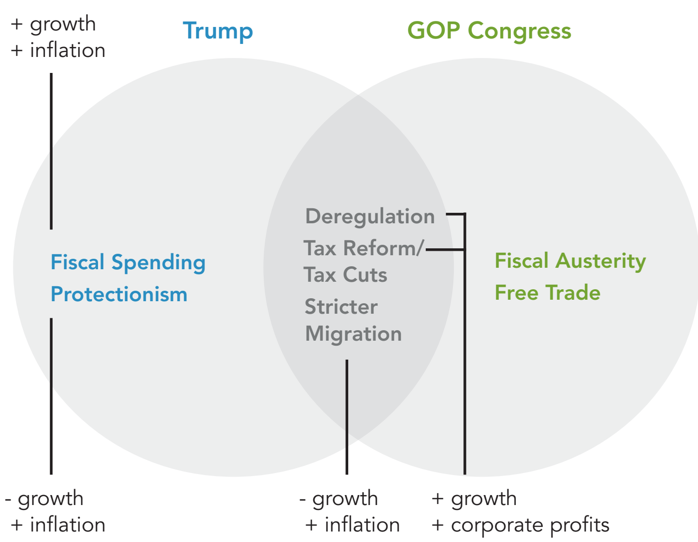
	Why rates are low	What might push them up
	Fundamentals	
Cyclical and secular	Slow growth	Better than expected growth
	Low inflation	Higher than expected inflation
	Monetary easing	Less easy monetary policies
	Technicals	
Reduced supply	Quantitative easing	Less QE than expected
	Fiscal tightening	Fiscal easing
Increased demand	Regulatory backdrop	(Very low probability of change)
	Demographics	(Very low probability of change)

For illustration only. Source: Fidelity Investments (AART).

- U.S. growth accelerates materially in 2017, presumably boosted by fiscal stimulus and pro-business policies, causing the economy to overheat. This faster-growth scenario would likely be accompanied by higher inflation, a pick-up in global growth, higher commodity prices, and a Fed that hikes rates but stays patient, and is generally perceived as behind the curve.
- U.S. growth is stable but does not meaningfully accelerate, presumably because policies are not as effective or growth-oriented as hoped, which leaves the economy rolling slowly toward late cycle. This pattern might feel similar to much of what occurred in 2016. The Fed may still hike patiently but would be perceived as being even with or ahead of the curve.

Over time, government bond yields (such as the 10-year Treasury) generally should correlate with the long-term rate of economic growth. On a secular basis, if rates are driven by growth and inflation, they should be around 3.5% to 4% (our current forecast for nominal GDP growth is 3.6%). However, the 10-year Treasury is

EXHIBIT 2: Varying policy scenarios will have different implications for the economy, rates, and inflation.



For illustration only. Source: Fidelity Investments, as of Dec. 12, 2016.

yielding only 2.5% as of mid-December, even though it has risen considerably since mid-2016. Therefore, **our 2017 forecast is that rates will remain low relative to their history, but they should trend higher than they are today.** Rates would need to increase by another 100 basis points or so to reach the level where we project long-term GDP to be. While by no means certain, it is possible that the secular era of rising globalization, falling inflation, and declining bond yields has reached an end.

Inflation outlook for 2017

Though the new administration increases the uncertainty around the outlook, higher oil prices and continued wage growth are primed to generate a more meaningful rise in inflation. During the past year, headline CPI has accelerated from 0.0% to 1.5% year-over-year, while core inflation (which excludes food and energy) has risen from 1.9% to 2.2%. The Treasury market's long-term inflation expectations have begun to drift higher, although they remain subdued relative to history and the Fed's inflation target. With core inflation firm and oil prices poised to rise above early-2016 trough levels, headline inflation could approach 3% by the end of the first quarter of 2017.

Asset allocation implications of rising rates

Rising rates affect different asset categories in different ways. Here are some asset allocation implications investors may wish to consider when positioning their portfolios for a rising-rate environment.

Fixed income

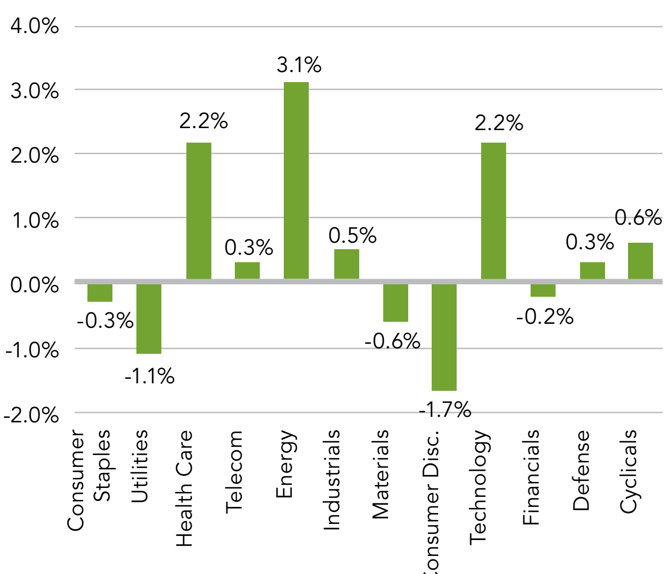
Most investors are aware that bond prices fall as rates rise. But higher rates do not always coincide with negative returns. There are a number of bond sectors and strategies investors can use to their advantage when interest rates are rising. Consider the following:

Short duration: Amid historically low bond rates, investors who sought higher yields in longer-maturity debt may have overexposed their portfolios to interest-rate risk. Short-duration investments can help mitigate that risk. When rates rise (and over the long term), short-duration investments can generate positive returns due to their relatively consistent interest income, and offer the ability to reinvest in comparatively shorter periods. A barbell strategy, with short duration on one end and longer-duration exposure on the other, may also outperform a bulleted intermediate strategy.

High-yield bonds: Relative to investment-grade government debt, bonds with higher yields—such as high-income corporates—tend to be less sensitive to rising interest rates because the higher income these bonds earn to compensate for greater default risk may offset the price declines from higher rates.

Foreign government debt: Investing in developed-market investment-grade debt outside the U.S. can help diversify a bond portfolio and provide a hedge against rising rates at home. Foreign debt may be a particularly timely strategy, since so many countries around the world are currently easing rates. Of course, foreign-exchange rates are an important consideration, because a change in the value of a country's currency relative to the dollar can undermine the performance of non-U.S. debt.

EXHIBIT 3: The energy, technology, and health care sectors have performed best in a rising rate environment.



Source: OECD and Fidelity Investments, as of Sep 30, 2016. See page 6 for methodology.

TIPS (Treasury Inflation-Protected Securities): TIPS have outperformed conventional Treasuries of late, partly because many of the new administration's policies are expected to be inflationary (e.g., corporate tax reforms, more restrictive trade policies). While we are constructive on the value of TIPS as part of an overall diversified portfolio, our current outlook is cautious given that 10-year breakevens have recovered from their post-financial-crisis lows in February and are now approaching their long-term average.

Floating-rate bonds: Unlike fixed-rate bonds, the interest rate on floating-rate debt adjusts regularly to stay on pace with short-term interest rates. If rates continue to rise, floating-rate bonds could do well. Floating-rate bonds also tend to have short duration, so coupling them with TIPS can provide attractive diversification.

MBS (mortgage-backed securities): MBS are a high-quality alternative to Treasuries and can offer an opportunity to pick up some incremental yield. However, MBS generally underperform Treasuries when interest-rate volatility rises. It will be important to monitor the relative pricing of mortgage securities to be sure to be adequately compensated for higher market volatility.

Equity

The broad stock market has historically been modestly positive in the year following a rate hike cycle, with income-related equities demonstrating the most vulnerability. Here's a closer look at how various equity categories have responded to a rising-rate environment.

Equity sectors: During the past half-century, **energy, technology, and health care** have been the bestperforming sectors relative to the market when rates are on the rise (Exhibit 3), while consumer discretionary and utilities have done the worst. Though its historical performance has been mixed when rates rise, the financials sector could do well in this rate cycle. Credit has an overwhelming effect on the critical factor of relative earnings growth. In a profit recovery as strong as this one could be—given potential tax and regulatory changes—there is strong potential for improved credit, which could boost financials relative performance

However, the sector performance story can change depending on whether rate hikes come in a growing economy, or during an economic slowdown. In a growing economy, cyclical sectors have significantly outperformed, most notably **technology**. Conversely, in a slowing economy, defensive sectors provided better average performance, led by **health care**.

Factors: Since mid-2016, small-caps have beaten large-caps and value has done better than growth. This may continue in 2017 if rates continue to rise. The performance of low-volatility strategies has tapered off since Q3, as has momentum, which is still working off the low-vol push from earlier in the year. Quality also has underperformed of late, although dividend performance, due to its relationship with valuation, has been holding its own on a sector-neutral basis.

Like sectors, individual factors are driven by different dynamics and tend to behave differently amid varying market and economic environments. Most factors are not highly correlated with one another; they are driven by changing market anomalies and tend to pay off at different times. Although certain individual factors have led to excess returns over the long term, no single factor works all the time, and diversifying across multiple factor strategies may be a sound option for long-term investors.

Dividend-paying stocks: Rising bond yields and the increased prospects for higher policy rates have caused sectors with the highest dividend yields to suffer lately, as bond yields have become relatively more attractive. Although income-producing equities in the aggregate have held up, the tailwind of a low and declining rate backdrop is likely to become a headwind going forward. However, dividend-yielding stocks are a heterogeneous group, and lower-payout, faster-growing dividend payers have historically held up well in rising-rate environments. Remember, over the long term, dividend-paying stocks have offered compelling returns relative to non-dividend-paying stocks, and have done so with lower volatility.

Real return assets

Real return is a multi-asset-class strategy that seeks real (inflation-adjusted) return by investing in a diversified mix of securities with inflation-fighting potential. Real return assets include floating-rate debt, real estate-related investments, commodities, and inflation-protected securities. Inflation, even at 2%, can be insidious to the returns of a portfolio. Real return assets can provide a hedge against inflation, have performed well in rising-rate environments, and have a very low correlation to stocks and bonds.

In closing, 2017 may be a year well-suited for active management

The current environment of policy uncertainty and volatility has prompted many industry observers to suggest that there will be more opportunity for active management in 2017—in both the equity and bond markets—than there has been in recent years.

The correlation between and within asset classes has trended lower recently, meaning return dispersion has increased. This gives active managers an opportunity to identify investments with higher potential returns. Additionally, actively managed strategies may increase potential returns in a wide variety of interest-rate, credit, equity, and volatility environments.

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Index definitions
The S&P 500® Index is a market capitalization–weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 is a registered service mark of Standard & Poor's Financial Services LLC.

Sectors classified in accordance with the Global Industry Classification Standard (GICS®).

Methodology
Exhibit 3 reflects average returns for periods when the federal funds rate was rising, from Jan. 1962 to Sep 2016. Sector returns based on a proprietary Fidelity database of stock returns. Stocks sorted into sectors using the GICS® classification for the universe of the 3,000 largest U.S. stocks. The index was market-capitalization weighted and reconstituted monthly. Rising rate periods start in the month when the year-over-year (yoy) fed funds rate rises and ends when the yoy funds rate falls. Average relative performance shows simple average of cumulative returns during each rising rate period, relative to the overall universe of 3,000 stocks. Defense is a simple average of the average relative performance for consumer staples, utilities, health care, and telecom during all periods of rising rates. All other sectors were considered cyclical. Source: OECD and Fidelity Investments, as of Sep 30, 2016.

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