



• FLASH REPORT: GLOBAL FIXED INCOME •

STRATEGIES FOR A RISING RATE ENVIRONMENT

Rising interest rates. The question is when, not if, rates will rise. The entire yield curve remains artificially low, a combination of skittish investors and government intervention in the bond markets.

SOME FACTS ABOUT RISING RATES. When interest rates increase, they tend to do so sharply. Chart 1 shows that movements in yield on the 10-year Treasury bond can be violent in either direction. We have not had a sustained rally in rates (and therefore a sustained decline in bond prices) since the 1970s. Therefore,

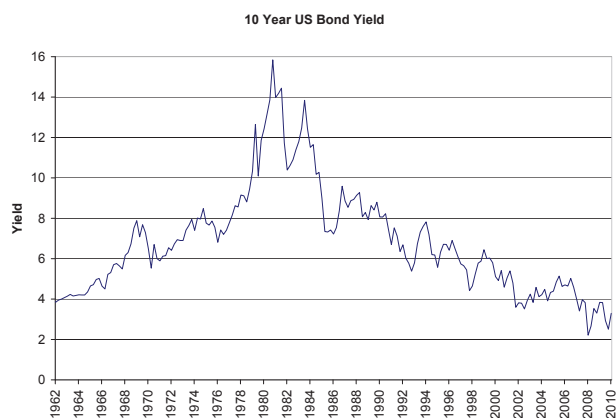
it is difficult to know precisely how financial assets, both equities and fixed income, will react in such an environment. But we can make some reasonable inferences based on the interest rate increases we have experienced during the more recent past.

Table 2 highlights the performance of several segments of the fixed income markets during periods of rising interest rates¹. Nothing here is particularly new or surprising. Rising interest rates are more impactful on longer duration bonds. Shorter term bonds perform better during rising rate environments, though they may not necessarily have positive returns. To the extent that rising rates are associated with a stronger economic environment, credit sensitive bonds tend to outperform government bonds. For credit sensitive bonds, especially high yield, their higher coupon payment moves current cash flow earlier, thereby reducing duration and interest rate sensitivity.

The intersection of short duration and credit sensitivity are traded bank loans, often referred to as “senior secured loans,” as they represent a superior claim in bankruptcy to general corporate and other unsecured debt. These securities are floating rate, where interest varies with common benchmark rates such as LIBOR or the Prime Rate.

Treasury Inflation-Protected Securities (TIPS) are often assumed to provide protection in a rising rate

CHART 1: TREASURY BOND YIELD



Source: Bloomberg

TABLE 2: RISING INTEREST RATE ENVIRONMENT

	10/31/89 - 4/30/90	10/29/93 - 11/30/94	1/29/99 - 1/31/00	10/31/01 - 3/21/02	6/30/05 - 5/31/06
Barclays Capital US Treasury Long	-5.88	-11.09	-8.27	-4.24	-7.02
Barclays Capital US Short Treasury	3.84	4.00	4.71	0.66	3.41
Barclays Capital US Aggregate Government TIPS	-	-	1.67	-1.33	-1.92
JP Morgan GBI Global (Active)	-2.84	-2.12	-2.87	-1.23	-2.02
Citigroup H/Y Market	-3.00	-0.72	-0.60	5.26	4.60
CFSB Convertible Securities Index	-1.66	-2.84	31.05	0.97	9.39*
Credit Suisse Leveraged Loan Index	-	13.87	5.43	3.99	6.23
Merrill Preferred Stock Fixed Rate	-	-	-3.22	2.20	0.49
Lipper US Mortgage Funds Index	-	-5.71	-0.90	-1.15	-0.08

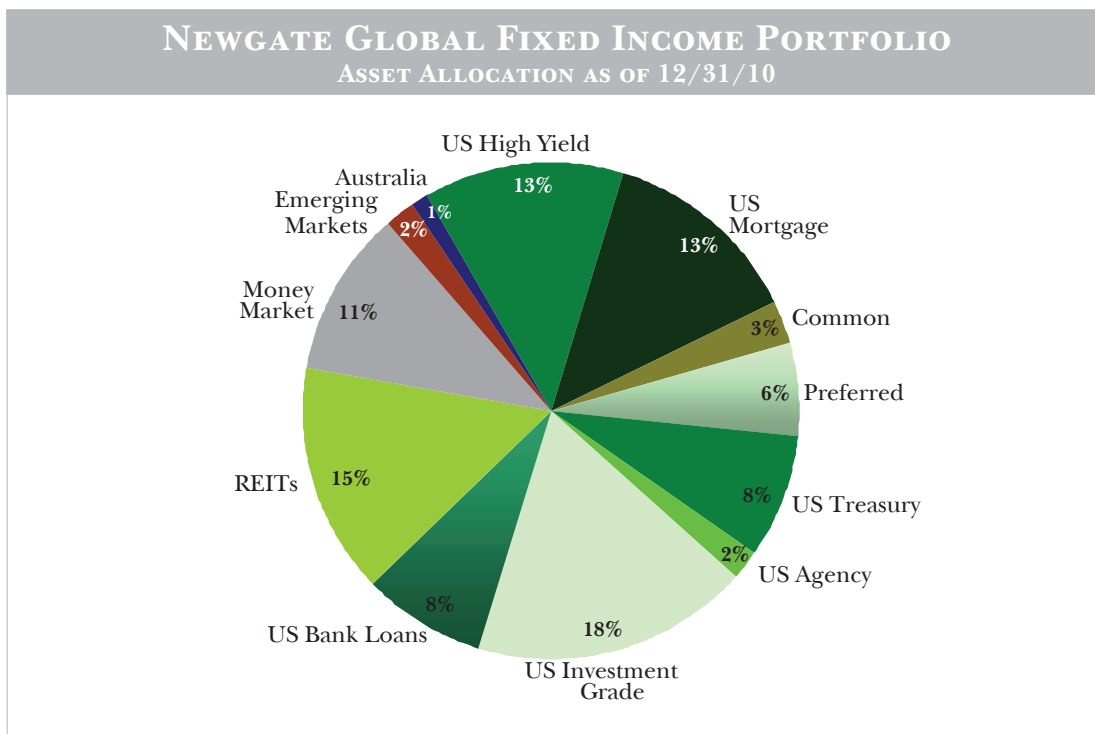
*Uses Merrill US Convertible for this time period

¹ Note that not all indices were available during all periods.

environment. However, this is not necessarily so. Inflation is defined by the Consumer Price Index (CPI), which also includes adjustments for real estate and improvement in product quality. It is possible to have rising interest rates but still see only modest gains in the CPI, and therefore only modest adjustments in TIPS pricing.

Given the somewhat volatile nature of all fixed income markets during a rising rate environment,

not all of these strategies may be appropriate, or they may not necessarily be appropriate at all points in the cycle. Newgate’s Global Fixed Income Portfolio allocates strategically across these and other segments of the fixed income markets. While there is risk in all segments of the market, ironically in a rising rate environment, it is the “safest” – government bonds – that may in fact have the most to lose. ♦



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