Observations and Perspectives:

Terri Spath, CFA, CPA®
Chief Investment Officer

Terri Spath joined Sierra Mutual Funds in 2015 and has more than 27 years of investment management experience. She is responsible for market and economic analysis, portfolio allocation and investment strategy for the firm.

"We expect interest rates to go up and this is what you might do about it."

Look Out Above! Rates Are Going Up.

About fifty days into the new administration and the trend we have observed since July 2016 remains intact: interest rates are going up.

As measured by the 10-year Treasury note, interest rates bottomed last July with a low closing post of 1.37%. Shortly thereafter, markets began to recognize that these levels were not consistent with the faint smell of inflation infusing the autumn air and with the data showing economic stabilization and recovery. Treasury bonds began to sell off, pushing interest rates upwards.

By October, Hillary Clinton was widely expected to be victorious in the Presidential election, perhaps even enjoy a landslide, and Donald Trump was not broadly recognized as a viable candidate. When Trump did pull off his historic win, the inflationary flames were fanned. His platform of fiscal spending, deregulation and tax cuts are designed to shoot adrenaline into the growth trajectory of the U.S. economy. These policies spur job growth and rising wages, boosting confidence, spending and ultimately higher prices (inflation). Inflation means higher interest rates.

Fast forward to 2017: commitment to a regulatory overhaul of the federal government has been a hallmark of the first few days and weeks of the Trump presidency. Campaign promises for lower taxes on corporations and individuals have also been repeated loudly. Most recently, in an address to Congress, a one trillion infrastructure plan was announced – that's 12 zeros and 4 commas: $1,000,000,000,000 for spending on roads, energy pipelines, utilities and more.

Obviously, smarter regulation, lower taxes and increases in government spending are viewed positively and it is, in many ways. Mingle these policies in with an economy that is already firming with a tightening labor market: the already flickering inflation is fanned.

Longer term, it isn't clear how this will all play out but in the shorter or medium term, it is unambiguous that the aggressive fiscal policies introduced at this stage of the economic cycle will push up longer-term interest rates. Monetary policy will also encourage higher rates. The Federal Reserve has four press conferences this year and we assign a high probability of a rate increase at each one.

We expect Interest rates to go up and this is what you might do about it. When it comes to fixed-income, we believe it's important to go a-la-carte as certain classes of bonds are sure to do well in a rising rate environment while others are sure to lose ground.

We like high-yield corporate bonds for their historic high correlation to U.S. stocks with far less volatility. Over the past year, an improving economic outlook coupled with a recovery in oil prices add up to falling default risk and higher prices. These trends are still intact. The coupons are big too, offering a yield right now north of 6%.
Floating rate loans are more than just a pretty story. With coupons that adjust with short-term rates and low volatility, we feel these instruments offer attractive risk-adjusted returns in this environment as well.

As active managers, we seek to build bond portfolios that will make money and preserve capital in an environment where interest rates are going to be higher. Rates have been rising since last July and our fixed-income strategies have delivered positive results in that period. We believe the rising rate trend can continue, given the policy mix that Trump is initiating, and periods of rising rates will be repeated.

We believe the biggest mistake investors can make in this environment is to do nothing. We are very active and unconstrained in our opportunity set. Active management means we can adeptly invest in the strength of select fixed income opportunities while avoiding the weakness in others.

3184-NLD-3/2/2017