Dan Fuss and the Long-Term Outlook for Interest Rates

By Robert Huebscher
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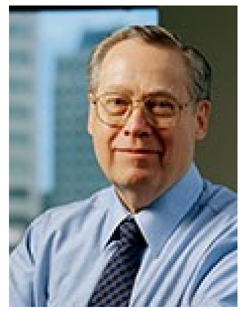
When three prominent bond managers say interest rates will head upwards, it's time to ask whether you want to stay invested in this asset class.

According to Dan Fuss, we are in the early stages on a long-term rise in interest rates. Fuss, the highly respected bond manager at Boston's Loomis Sayles & Company, spoke at a panel discussion at the recent Financial Advisor Symposium in Florida.

Carl Kaufman

Margaret Patel



Dan Fuss

Fuss was joined on the panel by Carl Kaufman, who is in charge of fixed-income strategy at Osterweis Capital Management in San Francisco, and Margaret Patel, who is a lead portfolio manager at Evergreen Investments in Boston.

Because the US and foreign central banks are keeping rates low, Fuss said, that rise will not start soon. The secular outlook, however, will not support low interest rates, he said.

Bond managers will need to deliver value through bond-picking, Fuss admitted, because they will be swimming upstream against rising interest rates. This implies that long-term investors seeking safety and stability of income should look beyond fixed income.

Indeed, the panelists agreed that the equity markets offer attractive opportunities for income-oriented investors.

The road to high interest rates

Corporations are not raising capital through the credit markets and bond funds – in both the separate-account and mutual fund spaces – are seeing record inflows, Fuss said, which means that supply and demand imbalances will keep rates low in the near term.

Longer term, Fuss called credit fundamentals at the federal and municipal levels "absolutely awful," and that is what will drive interest rates higher. He does not think it will be possible to bring the US deficit below 4.5% of GDP – roughly twice its historical average.

As a result, he said, "The incremental borrower of funds will be the US Treasury and the net effect is that the credit markets will ration money to the private sector by price."

Spreads on corporate bonds, relative to Treasury bonds, are currently "decent," Fuss said. Companies with good credit ratings will be able to access the capital markets, he said, but those with medium or poorer credit will have problems.

The outlook for real returns on bonds is unattractive, Fuss said, and, therefore, the environment lends itself to "substituting market risk for specific risk." Bond managers like Fuss will earn returns by picking those bonds that will perform the best.

Kaufman agreed with Fuss, and said "interest rates have nowhere to go but up." He said that government intervention is keeping interest rates artificially low and that "left to their own devices, rates would go higher."

"We aren't returning to the wistful days of the 1980s when you could get monstrous yields on Treasuries, although the fundamentals could support that," he said.

Patel forecast that rates on five-year and shorter Treasury securities will continue to move down, because the carry trade will continue to allow investors to borrow at near-zero interest rates and buy those securities, further depressing their prices.

Over the longer term, however, she agreed with Fuss and Kaufman and said there will come "an inflection point" when rates will head higher. She said this will not happen over the next six months and it may be a year or more away.

Corporate bonds versus dividend-paying stocks

Patel said the outlook for risk-adjusted returns for corporate investors is extremely attractive. She noted that some analysts are forecasting the corporate default rate to decline to 6%-7% from its current level of 12%-14% and that corporate spreads will tighten as the economic recovery proceeds.

"Good quality double-A corporate bonds, such as Proctor and Gamble, could trade just on top of Treasury bonds," Patel said. Corporate bonds are a "great place to be" right now.

Kaufman also expects corporate spreads to tighten, although his forecast relies on rising Treasury yields rather than declining corporate yields. Corporate returns therefore will not come from capital appreciation.

Corporate bonds may not be the best place to find income, though. Patel cited "incredible" situations where yields on short-term AA corporate bonds are equal to or less than the dividend yields on the issuer's common stock. Proctor & Gamble has six-year bonds yielding 2.7%, and their stock pays 3%. "Unless P&G destroys the value of their company, you will make more income buying the stock," she said. There are dozens of such situations, she said, including Clorox, which has a 3.55% Baa bond and pays 3.5% in dividends on its common stock.

The underlying cause of this dislocation, according to Patel, is artificially low short-term rates and uncertainty in the equity markets. Common stocks provide hedging benefits against inflation, she added.

Kaufman noted that stocks yielded more that bonds in the 1930s, but that changed in the 1950s, and now we are returning to a paradigm of higher perceived risk in equities to justify their higher dividend yields.

The trigger that sets off an increase in interest rates could be the unwinding of the carry trade, Fuss said. Leverage has built up in the market, and once these trades unwind they could do so rapidly across markets, with the two-year Treasury an "obvious candidate" to get hit.

Will government policies keep interest rates low?

Kaufman does not expect an inflationary spiral or a Japanese lost decade. He believes that the possibility of losing seats in the 2010 elections will force the Democrats to enact policies to stimulate economic growth. He did not say what those policies might be, other than an inevitable raising of interest rates by the Fed.

"As far as the Fed being able to control the monetary destiny, I think that's wishful thinking," Patel said, adding that its track record has not been good recently. "We could see them turning the dials and things getting out-of-control."

Fuss said that although the Fed has indicated it will provide notice before it raises rates, even that notice will not avoid a "bumpy" situation as the carry trade unwinds. "There are just so many people doing this," he said.

But the unwinding will not be "devastating," he added, and should provide a short-lived buying opportunity.

Patel agreed that a solvency crisis, like the one that occurred in the fall of 2008, is unlikely because the banking system now is much better capitalized.

Adding to the upward pressure on interest rates is the burgeoning crisis in state and local government finance. All three panelists agreed that the unfunded liabilities in pension funds pose a systemic danger that may ultimately require federal subsidies or a bailout. Fuss said the long-term solution is to remove inflation-escalation clauses from pension contracts.

Implications for advisors

You will rarely hear a fund manager go beyond saying that the current environment favors stock picking or, in this case, bond picking. Fuss' statement that bond managers will need to substitute market risk for specific risk is not unusual; anything to the contrary is tantamount to an indictment of active management.

In this case, though, all three fund managers are saying their asset class will deliver below-average and possibly negative returns over the long term. Advisors are therefore betting purely on the security selection skill of the managers, who operate in a highly competitive arena. The headwinds posed by a secular rise in interest rates could easily overwhelm any value individual security selection adds.

Over the short term, though, the outlook for nominal bonds is reasonably good. Advisors who believe the long-term outlook of higher interest rates must ask whether they can correctly time the decision to pare back their fixed income allocation before the "inflection point" is reached or the carry trade unwinds.

Advisors seeking long-term income solutions should look at high-quality dividend paying stocks, TIPS, or other inflation-hedged investments.

The bearish forecast for nominal bonds is not universally held; Gary Shilling, as we note in our article in this issue, expects sustained deflation and is bullish on bonds.