The Direction of Interest Rates

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Markets do not operate in a vacuum. A host of factors should be considered when attempting to predict near-term directions in interest rates. These factors fluctuate over the next day, week, month, or quarter, making markets difficult to accurately predict. Therefore, at DoubleLine, when our Fixed Income Asset Allocation (FIAA) team is making investment decisions, we focus on the long-term and allocate our portfolios based upon an investment horizon of approximately 12 to 24 months. Positioning a portfolio based upon short-term market forecasts is not consistent with DoubleLine’s cardinal mandate: striving for better risk-adjusted returns. We believe our longer-term approach is in investors’ best interest and avoids potential losses from knee-jerk reactions to short-term market fluctuations.

DoubleLine’s long-term forecast has been, and remains, that interest rates will rise. In fact, we have been calling for higher interest rates across the U.S. Treasury (UST) curve since the bottom of the 10-year UST yield on July 8, 2016. Two days prior, Jeffrey Gundlach, DoubleLine’s Chief Investment Officer, said on CNBC that we were “maximum negative” on the 10-year UST as it set a new intra-day low yield of 1.32%. At that time some asset managers were predicting that 10-year UST yields would fall below 1%. Subsequently, Mr. Gundlach was featured in Barron’s November 2016 issue noting that he expected the 10-year UST yield to rise to 6% by 2021 due to a variety of factors, including President Trump’s pro-business agenda leading to stronger economic growth and inflation, and an expanding government deficit as a result of fiscal stimulus. Since its low on July 8, 2016, 10-year UST yields have more than doubled, rising 188 basis points (bps) to their recent high of 3.23% on November 8, 2018. If interest rates continue to rise at the same pace we’ve seen over the past two years, interest rates will hit our forecasted level in 2021. This long-term forecast for higher interest rates is based on four market factors: increased quantitative tightening in the U.S., the reduction of global quantitative easing (QE), increased UST supply, and the Federal Reserve (the Fed) raising the Fed Funds Target Rate. As long as these four market factors remain in play, we believe 10-year UST yields have the potential to rise to 6% by 2021.

Market Factors:

1. Increased Quantitative Tightening (QT)

The Fed began systematically reducing their UST and Agency Mortgage-Backed Security (MBS) holdings on October 13, 2017. The decision to cease purchasing these assets removes a substantial buyer from the market place. All things being equal, the removal of the Fed as a major buyer, puts upward pressure on interest rates. Almost one full year into the Fed’s QT program, the Fed has reduced its balance sheet by roughly $295 billion, a mere drop in the bucket considering the roughly $4.5 trillion of assets it accumulated prior to the beginning of the balance sheet unwind. However, the systematic balance sheet reduction took another step forward in October 2018, with up to $50 billion rolling off the balance sheet each month. This will potentially create an additional $600 billion of annual bond supply putting additional upward pressure on interest rates.

2. Reduction of Global Quantitative Easing (QE)

Global QE served its purpose and pushed rates lower across the globe as Central Banks purchased bonds. As evidenced by the chart to the right, we are currently seeing the lowest amount of QE globally since 2012 as the European Central Bank (ECB) and Bank of Japan (BoJ) are moving towards policy normalization. The ECB made its final round of €30 billion worth of bond purchases in September and has since reduced purchases to approximately €15 billion for the final three months of 2018. The ECB is expected to end its QE purchases at the start of 2019, and the market is pricing in a 90% chance of an ECB rate hike in October of 2019. Similarly, on July 31, 2018, the BoJ made the most significant change to its policy in two years. It announced increased flexibility on its 10-year yield target of 0%, allowing for a range of plus or minus 20 bps, which could lead to a lower amount of bond purchases. If the ECB and BoJ continue to move away from QE we may finally start to see rates rise globally and not solely in the U.S., putting additional upward pressure on the direction of domestic interest rates.

2. Source: Topdown Charts, Bloomberg, DoubleLine, as of October 31, 2018
3. As measured by Bloomberg’s World Interest Rate Probability (WIRP) function on October 31, 2018
3. Increased U.S. Treasury Supply

Treasury auctions are projected to reach all-time highs as the U.S. Federal Government runs a forecasted annual budget deficit exceeding $1 trillion in 2020 and beyond (see Figure 3). Further complicating the issue is the U.S.’s aging population, recently implemented tax cuts and increased government spending under the current administration. These factors will likely lead to an uptick in government borrowing thus increasing the amount of UST issuance and putting upward pressure on UST yields. Additionally, the Fed’s path towards policy normalization means its holdings of UST securities will continue to decline. While these bonds were on the Fed’s balance sheet, the Treasury department was relieved of the responsibility to pay interest on this debt as the government would have been paying itself. The reduction of the Fed’s balance sheet will mean increasing the debt servicing cost for the U.S. Government as non-U.S. Government bond holders will be owed interest on their holdings. Altogether, DoubleLine estimates that the U.S. could be looking at $1.9 trillion of UST supply in 2019 and increasing from there adding to the upward pressure on interest rates.

4. Fed Tightening on the Short-End

The Fed has hiked short-term rates by 25 bps eight times this cycle with the market pricing in a ninth hike in December 2018. Looking further out to 2019, the market is anticipating an additional two rate hikes, which would target a 3.00% upper bound level on the Fed Funds rate, while the Fed’s dot plot is targeting an additional one or two more rate hikes past 3.00%. This means short-term rates should continue to move higher over the remainder of the hiking cycle. The Fed’s decision to continue increasing the Fed Funds Target Rate should have a ripple effect on the long-end of the curve if higher inflation starts being priced into the bond market. Typically, late in the business cycle, inflation tends to tick higher as tight labor markets lead to higher wages and businesses are more willing to spend and invest in their future. With the unemployment rate at its lowest levels since 1969 and all sentiment measures near cycle highs, inflation has the potential to move higher. The Fed’s target inflation rate is 2%, and the Fed will continue to monitor key inflation measures when considering future rate hikes, as higher rates tend to tighten money supply and keep inflation in check.

Conclusion

As long as these four market factors continue to affect U.S. interest rates, DoubleLine believes that the long-term direction of rates will be higher, and that 10-year U.S. Treasury yields will move up towards 6% by 2021.

Higher rates pose a threat to the mark-to-market pricing of debt securities outstanding, because the value of these outstanding securities decline as a result of new issue securities coming to the market with a higher yield. This gives fixed income managers the opportunity to reinvest capital at higher interest rates, and ultimately increase the income paid to investors. While this may be beneficial in the long run, there is a potentially painful road ahead as the 10-year UST yield climbs toward 6%. However, this pain can be mitigated in fixed income portfolios through active risk management.

Risk management is at the core of our investment process. Our teams employ a robust investment approach based on top-down global macroeconomic analysis combined with bottom-up security selection. We actively manage the risks of our strategies through sector allocations, security selection, overall credit quality and duration of our portfolios, and ongoing monitoring of portfolio and individual security holdings. DoubleLine recommends keeping duration shorter than respective benchmarks, maintaining diversification, and keeping a watchful eye on credit quality as we move through the late phase of the business cycle.

4. Source: Congressional Budget Office April 2018 Forecasts, Bloomberg, DoubleLine. Note 2017 data is actual, remainder are estimates.
5. Source: Bloomberg, DoubleLine; As of December 4, 2018
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Definitions

Bloomberg WIRP Function - The probability of rate hikes at upcoming policy meetings as forecasted by Fed Fund futures forward curves.
Fed Funds Target Rate - The interest rate at which depository institutions lend balances at the Federal Reserve to other depository institutions overnight. The rates reported below are based upon the Fed Funds Target Rates on the first day of each respective month.
Basis Point (bps) - One hundredth of one percent, used chiefly in expressing differences of interest rates.
Fed Dot Plot - Federal Reserve officials plot their expected path of interest rates hikes. The dot plot is the projections of each FOMC participant’s assessment of the appropriate midpoint of the target range for the federal funds rate.
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