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MARKET INSIGHTS

The latest Market Insights
from the Connected Wealth team

Rising rates - a Connected Wealth perspective

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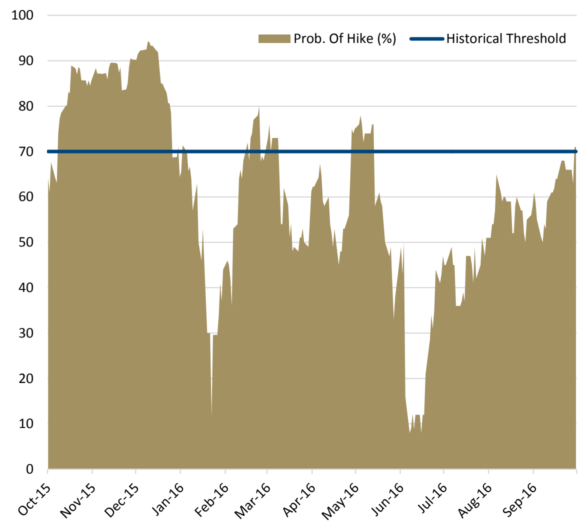
Regular readers may have picked up on a theme in our publications over the past few weeks. We touched on both Cyclical Yield and Inflation. Both of these topics deal with idea that the market may be heading down the path to higher bond yields. Quantitative Easing, in the form of large scale asset purchases, along with low global growth have put unprecedented pressure on bonds yields, driving some countries into negative territory. This pressure appears to be easing for now and, at some point, the moderately positive domestic economic data will begin to matter more. We also have the Fed likely raising rates before year's end. The implied probability currently sits at ~70%, which is in line with how the market priced in previous hikes. If the Fed moves in December, nobody can say that they were caught by surprise (Chart 1).

Chart 1 - Probability of a Fed Hike (%)



The 'lower for longer' camp appears to be getting crowded. Even so, we still believe that negative policy rates will not cross the Atlantic— or the Pacific, for that matter—for some time. We continue to view this central bank experiment from afar. Current yields are below what we would expect a fair-value level to be. What we witnessed in August was a severe undershoot of bond yields and markets are now slowly reversing. Bond market volatility has been high and will likely remain elevated throughout the end of the year, especially since all eyes are on the Fed and ECB meetings in December.

Even if the long-term trend is intact, brief pullbacks in the march lower can have a significant negative impact for the so-called 'safety bucket' of investors' portfolios. If they are not positioned properly.

Are bonds the safest investment? Years ago you would not have to think twice. Now the current investment climate poses some challenges to the convention. The cliché sentence would be that this time is different. While ZIRP and NIRP represent a new phenomenon, there is always the possibility to reverse course. Perhaps, once the 'new normal' becomes the commonly accepted view, the old normal may be new again. Just drive by any high school—what is old always has a way to come back into style.

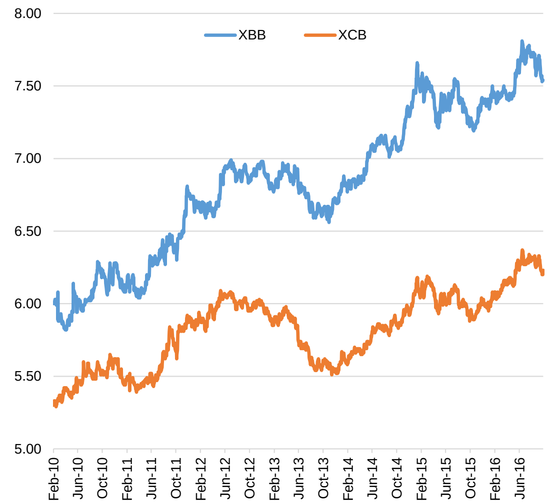
Bond Basics

It is almost impossible to hear or read about the bond markets without coming across the word "duration." But what does this term mean? From a quick search of Investopedia:

> *Duration is a measure of the sensitivity of the price -- the value of principal -- of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. Bond prices are said to have an inverse relationship with interest rates. Therefore, rising interest rates indicate bond prices are likely to fall, while declining interest rates indicate bond prices are likely to rise.*

We want to note the significant changes in the duration of the aggregate bond market. It has been increasing over the past years due to falling rates and extending maturities. Put simply, the bond market is much more sensitive to rate moves than it was before (Chart 2).

Chart 2 - Market duration rising over time

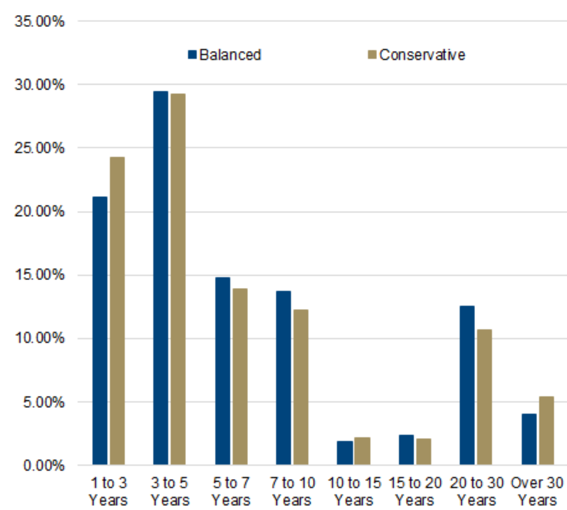


Connected Wealth Profiles

The Connected Wealth Investor Profiles represent our teams' recommended approach to implementing well-rounded portfolios. Our dedicated team of investment professionals monitors the macro environment and makes tactical adjustments across asset classes and geographies. We also make shifts between active and passive products. The end result is low cost, well diversified portfolios that combine both active mutual funds as well as ETFs.

In order to weather bouts of market volatility, it is prudent to allocate a portion of one's portfolio to safe investments. Especially for those nearing retirement who wish to dial down overall portfolio risk. Balance is important, but so is being opportunistic. Details of our fixed income positioning are outlined below.

Chart 3 - Connected Wealth Fixed Income Snapshot - Term to Maturity



Duration Risk

We've touched on duration and view being short duration as the principal way to protect against the risk of rising rates. We have a higher proportion of our fixed income portfolio invested in bonds with fewer than 5 years to maturity, in both our Balanced and Conservative profiles. Our active managers are also quite short duration at the moment (Chart 3).

High Yield

Besides duration, the other segment of the fixed income universe that makes us uncomfortable (from a risk/reward trade-off) is the high yield space. Spreads over government yields have compressed significantly, after blowing out earlier this year (Chart 4). High Yield bonds have been volatile over the past couple of years. This is not the type of behavior that most investors expect from their low-risk bucket. The risk has been rewarded but it also comes with red flags. High yield ETFs have had more than decent returns year to date. The iShares IBOXX High Yield ETF (HYG) has returned over 13%, nearly double the S&P 500's total return. Going forward, we find it hard to believe these outsized returns will persist. We have limited our exposure in the profiles to less than 3% non-investment grade bonds (Chart 5). Moreover, we still prefer credit exposure over straight government debt, as can be seen in the fixed income allocations below. (Charts 6 & 7)

Recap (TL/DR)

For security and peace of mind, and given our outlook for rates, we have tactically reduced duration across the mandates, reduced our fixed income allocations to slightly underweight, and removed almost all high yield exposure. We still prefer investment grade corporate debt over government, at this point in the market cycle.

Chart 4 - High yield spreads nearing lows

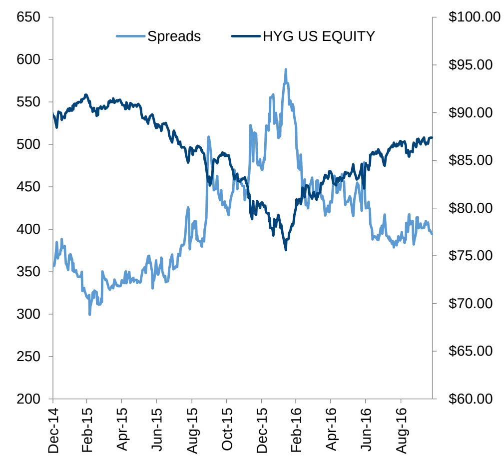
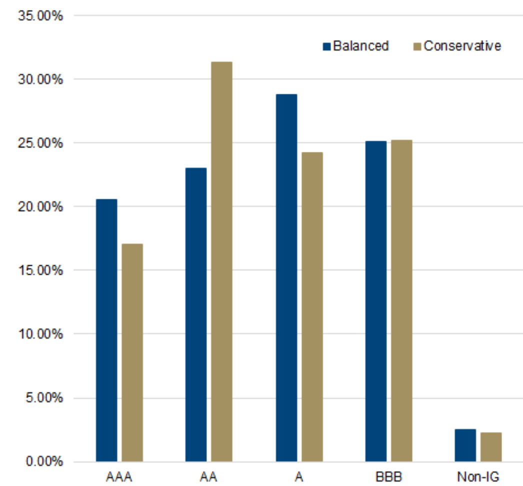
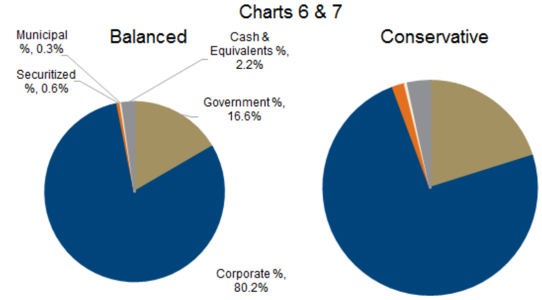


Chart 5 - Credit Quality of the Profiles



Charts 6 & 7



Charts are sourced to Bloomberg unless otherwise noted.