MERGANSER
CAPITAL MANAGEMENT

INVESTMENT MEMO

Merganser Today

Merganser has managed fixed income assets for institutional clients over the course of 30 years and six periods of increasing Fed Funds Rates.

Rate Hike Blues: Have We Heard This Song Before?

Capital markets investors are continuously arguing the timing and magnitude of a shift in Federal Reserve (Fed) policy from its current accommodative stance to a tighter approach. The Fed looks poised to step up to the mic and play what has become a familiar (and for many investors, foreboding) tune: the Rate Hike Blues. While the timing and size of any Fed rate hikes are debatable, most agree rate hikes are indeed coming and many expect a period of regular hikes. We believe it is useful to study the two most recent aggressive tightening regimes: the first during the Greenspan era and the more recent during the Bernanke era. While both sang a very different song, they both shared a (maybe) surprising melody.

Greenspan's "Lightnin' Quick Tightenin'"

Despite a lull in US economic activity in 1993 with GDP languishing at a 2.6% growth rate, the Fed commenced a programmatic tightening regime beginning in February 1994. US GDP growth had been healthy in 1992 at 4.3%, inflation hovered slightly above 3.0% and signs pointed toward a rapid return to stronger growth in 1994 (actual GDP growth was 4.1% in 1994).

The Federal Funds Target Rate (FFTR) was 3.00% when Greenspan's monetary policy tightening began. Through a regular series of rate hikes of between 25 basis points (bps) and 75 bps, the Fed ceased tightening in early 1995 with the FFTR at 6.00%.

During the tightening period the US Treasury (UST) yield curve shifted upward, though the change in shorter rates was more pronounced resulting in a "bear flattening" of the curve. Figure 1 below illustrates the yields across the curve before and after tightening.

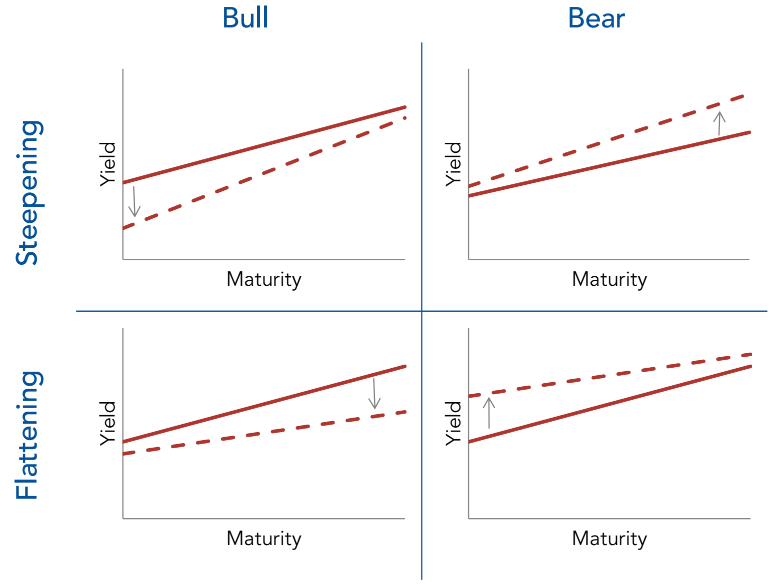
Figure 1: US Treasury Yields Before/After Greenspan Tightening

	2 Yr	5 Yr	10 Yr	30 Yr
February 1, 1994	4.12%	5.02%	5.70%	6.23%
February 28, 1995	6.79%	7.06%	7.22%	7.46%
Change	*2.67%*	*2.04%*	*1.52%*	*1.23%*

Source: Federal Reserve

Continued on next page >

Figure 2: Illustration of Bull/Bear Steepening and Flattening

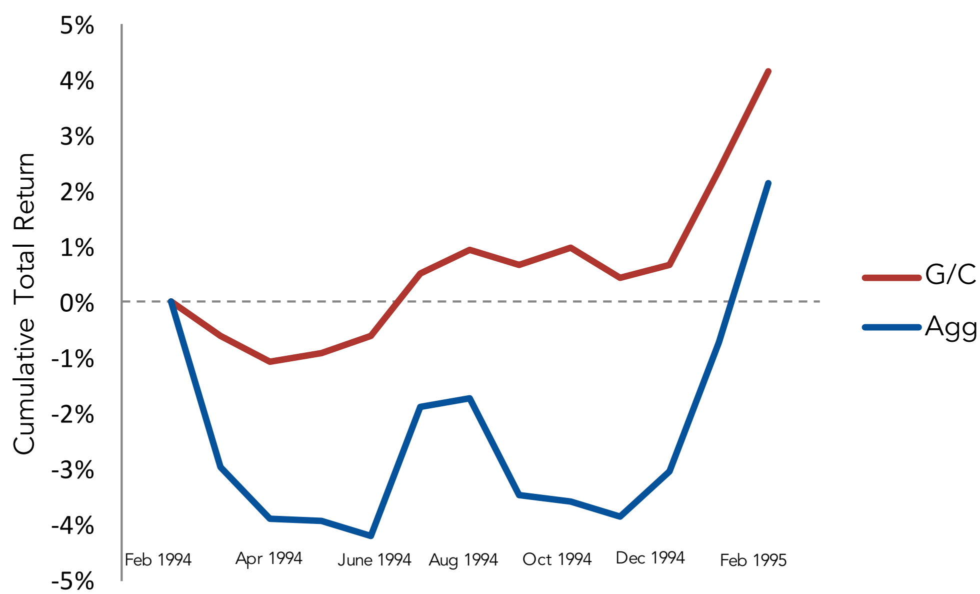


Source: Merganser

The Greenspan era exhibited a prototypical bear flattener

During a period of rising rates, such as the one described above, most investors would expect fixed income portfolios and indices to register negative returns based on the age-old truth that as bond yields go up, bond prices go down. However, depending on where the portfolio or index is positioned on the curve, the total returns can be demonstrably different. Indeed, the Barclays Aggregate Index (Agg), which largely represents the investable universe for traditional fixed income instruments across the yield curve (subject to certain index rules), generated a total return of 0.01% during the Greenspan tightening cycle from February 1, 1994 to February 28, 1995. Conversely, the Barclays 1-3 Year Government/Credit Index (Gov/Credit), which limits the universe to certain sectors and to shorter-dated maturities, generated a total return of 2.69% over the same timeframe despite a significant yield disadvantage relative to the Agg (about 150 bps lower) at the start of the cycle.

Figure 3: Cumulative Returns During Greenspan Rate Hike Cycle



Source: Barclays Live

Continued on next page >

Conventional wisdom would suggest that the part of the curve that increases the most would suffer from weaker returns. Various factors contribute to the disparate returns and it is worthwhile noting that the index, which focuses on the part of the yield curve (the 2 Yr area) that saw the largest increase in rates, also registered the strongest total return. Despite singing the blues, Greenspan kept fixed income markets positive over the cycle.

Bernanke's "Hiking to a Flat Curve"

The US economy was performing very well in mid-2004, growing at a rate of 4.2% over the prior 12 months. Inflation over the prior year was more subdued, ranging from 1.7% to 3.3%, but readings were trending higher. Commencing in June 2004, the Fed increased the FFTR at each of its meetings by 25 bps, moving the target rate from 1.00% to 5.25% over a two-year period. The table below shows the changes in rates from June 2004 to July 2006.

Just like Greenspan, Bernanke kept fixed income markets positive

Figure 4: US Treasury Yields Before/After Bernanke Tightening

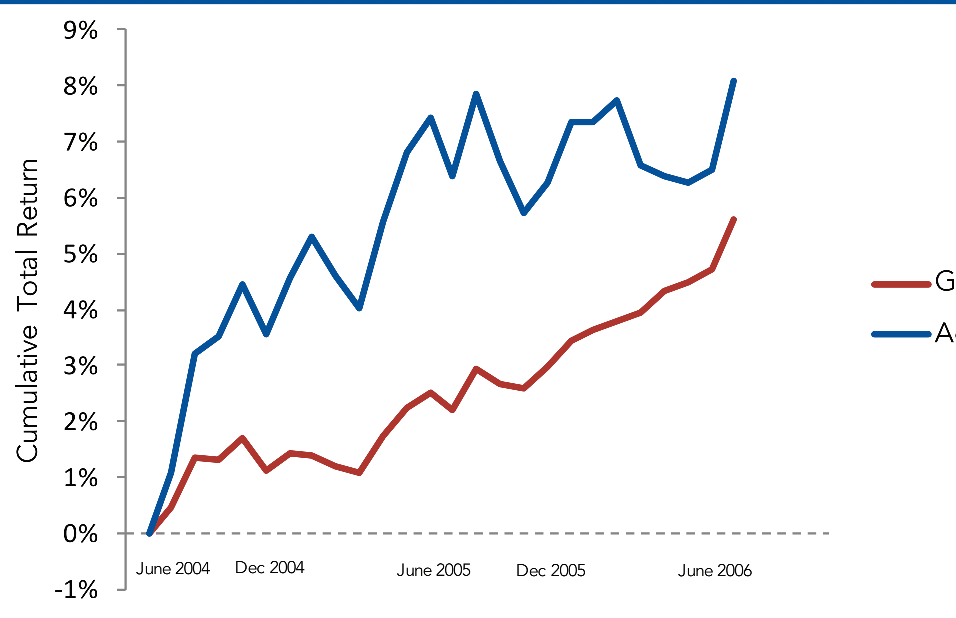
	2 Yr	5 Yr	10 Yr	30 Yr
June 1, 2004	2.54%	3.81%	4.66%	5.28%
July 31, 2006	4.97%	4.91%	4.99%	5.07%
Change	*2.43%*	*1.10%*	*0.33%*	*-0.21%*

Source: Federal Reserve

Similar to a decade earlier, the front end of the curve changed the most, as shown by the 2 Yr UST increasing markedly by 2.43%. Longer rates, however, held steady and even decreased by 21 bps for 30 Yr UST bonds.

During the Bernanke tightening cycle from June 1, 2004 to July 31, 2006, the Agg generated a total return of 7.98%. This was due in large part to the longer-duration securities included in the index benefitting from the modest rally at the long end of the curve and the ~190 bps

Figure 5: Cumulative Returns During Bernanke Rate Hike Cycle



Source: Barclays Live

Continued on next page >

of yield advantage over the Gov/Credit. Meanwhile, the Gov/Credit generated a cumulative total return of 5.03% over the same timeframe. Again, the short-dated index registered a positive total return during a period when the benchmark rate increased. Just like Greenspan, Bernanke's blues kept fixed income markets positive.

Yellen: Original Tune or Cover Song?

While some of the notes might remain the same, it is more likely that Chair Yellen will end up singing her own tune

Both of the Greenspan and Bernanke regimes were unique in the duration, speed, and magnitude of rate hikes and in the nature of underlying economic forces. In both cases however, total returns during the hiking period were positive; a positive melody despite a somber rhythm. That is not to claim that the current environment will have the same outcome. Just as the Bernanke tightening cycle was significantly different from the Greenspan tightening cycle, the current environment provides its own unique mixture of macroeconomic and financial factors that will likely result in an entirely unique experience. In that sense, while some of the notes might remain similar or even the same, it is more likely that Chair Yellen will end up singing her own tune when the FOMC decides to increase short term interest rates.

After a historic period of accommodative Fed policy, with the FFTR at the target range of 0.00% to 0.25% for more than five years in addition to three rounds of quantitative easing, we believe the FFTR is poised to rise. Exactly when and to what degree rates rise is open to debate, but a majority of economists forecast an increase at some point in 2015. The US economy has not enjoyed the robust growth that we witnessed when prior Fed leaders contemplated tightening monetary policy. The current economic recovery has not included a quarterly real GDP increase of more than 3.1% and economist forecasts mostly point to a continuation of uninspiring (by historical standards) growth. In addition, inflation continues to run below the Fed’s threshold to tighten monetary policy and the yield curve has persistently remained at low levels despite many calls for a rate jump.

Figure 6: Recap of Recent Rate Hike Cycles

	Greenspan	Bernanke	Today
Months of Increase Program	12	25	?
Number of Rate Increases	7	17	?
Total Rate Increase	3.00%	4.25%	?
Largest Increase	75 bps	25 bps	?
% Months with Negative Agg Returns	67%	36%	?
% Months with Negative 1-3 GC Returns	42%	32%	?
Unemployment Rate	6.6%	5.6%	5.5%
GDP Growth (YoY)	2.6%	4.2%	2.4%
Fed Funds Rate	3%	1%	0.25%

Source: Federal Reserve; Barclays Live

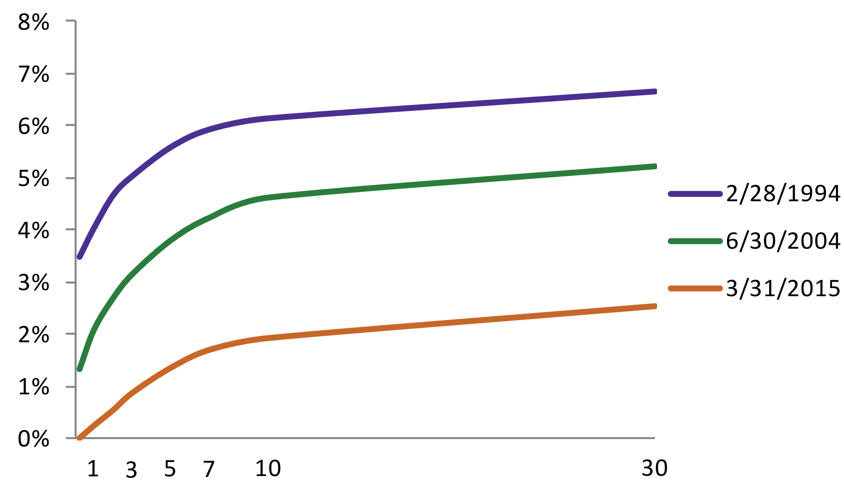
Figure 7 illustrates the current yield curve compared to the yield curve when the Greenspan and Bernanke rate-hike cycles began.

"Every Day We Have the Blues"

Conventional wisdom dictates that fixed income is not the most appealing sector during periods of rising interest rates; yet from a historical perspective, this thinking proves to be less than straight forward and oftentimes misleading. Furthermore, recent history highlights the

Continued on next page >

Figure 7: Yield Curve Comparison



Source: Federal Reserve

challenges market participants, Merganser included, face in attempting to accurately "time" secular shifts in the direction of interest rates.

What historical experience shows, in our view, is that attempting to time rates ignores the full-cycle economics of fixed income investing, as other effects, such as economic stability and asset bubbles, are significantly stronger signals for asset allocation decisions.

Fixed income portfolios can continue to play their traditonal, conservative role, even in a rising rate environment – preserving capital and generating a modest (or better) positive total return. Even when the tune is the blues.

Contact Information

Merganser Capital Management
99 High Street
Boston, MA 02110
www.merganser.com

Consultant Relations & Business Development
P: 617.528.4863
info@merganser.com