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Flattening yield curve highlights the potential in floating-rate assets

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- The yield curve continued to flatten, as the U.S. Federal Reserve raised the federal funds rate for the seventh time in this cycle, while long-term bonds traded in a range just under 3% in the second quarter.
- The rising rate environment has pushed most fixed-income sectors into negative territory for the first half of the year.
- In the U.S., a number of indicators like low employment, strong manufacturing growth, lower corporate taxes and deregulation suggest the market may be underestimating inflationary forces, and potentially higher long-term rates.
- At the same time, elevated political risk and the possibility of a global trade war could put downward pressure on long-term yields.
- With the Fed and the market in line on fed funds rate expectations in 2018 and directionally in line for 2019, we believe there is greater clarity regarding the direction of rates at the short end of the yield curve than at the long end.
- We believe various floating-rate investments could offer investors attractive risk-adjusted returns as the Fed continues to tighten/raise rates.

The second quarter saw a continued flattening of the U.S. yield curve, as the U.S. Federal Reserve kept tightening the short end, while the 10-year U.S. Treasury rate treaded water, trading in a range just under 3%. The yield on the 2-year Treasury rose 26 basis points (bps) to 2.53%, while the 10-year Treasury advanced just 12 bps to 2.86%. The spread between them narrowed from 47 bps to 33 bps. That is the smallest difference since August 2007 (Exhibit A), and close to inversion, where short-term rates are greater than long-term rates.

At its meeting on June 13, the Fed raised the benchmark fed funds rate by 25 bps to a range between 1.75% and 2% — its second rate hike this year, and the seventh since the tightening cycle began at the end of 2015. A majority of Fed officials now expect at least two more rate increases this year, up from a March prediction of one more 2018 hike.

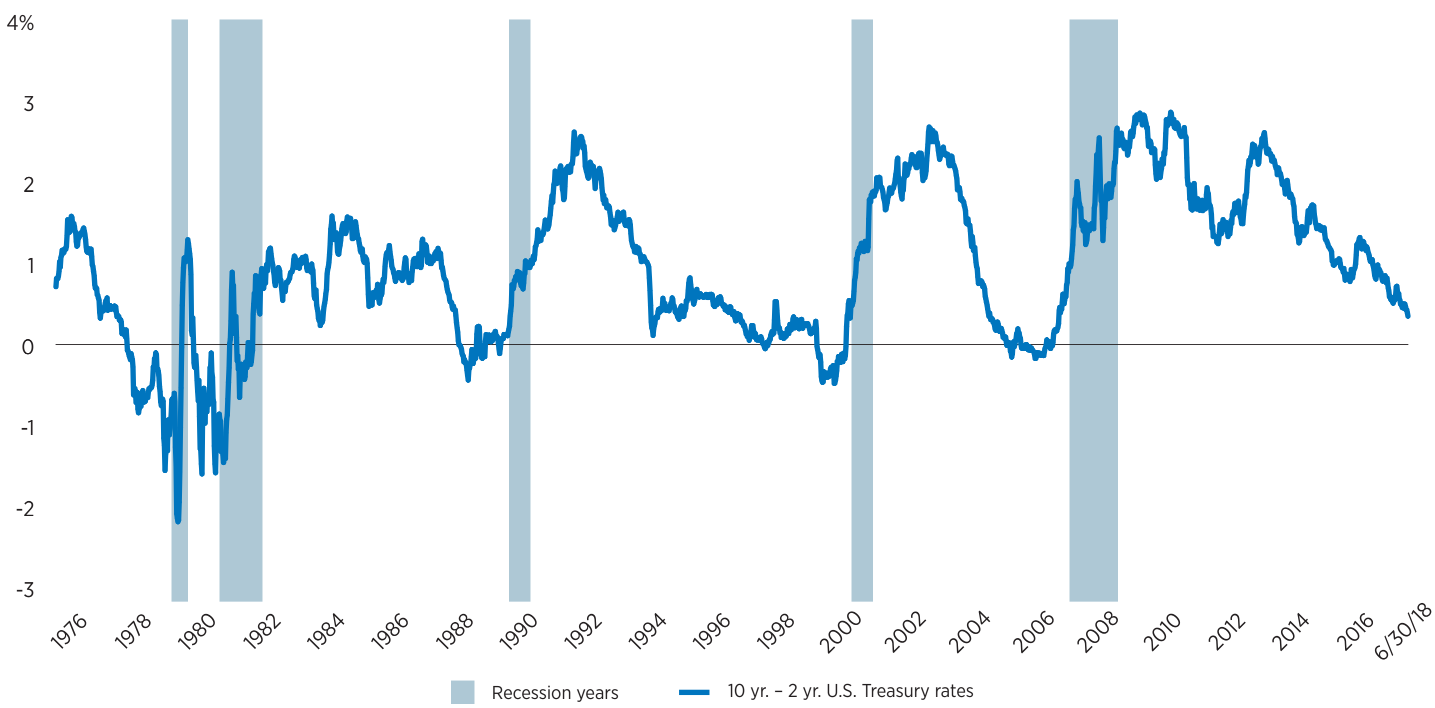
Fed Chairman Jerome Powell described the latest rate increase as "another sign that the U.S. economy is in great shape. Growth is strong. Labor markets are strong. Inflation is close to target." Real GDP grew by 2.8% in the third quarter, its fastest clip since 2015. The Purchasing Managers Index (PMI) released by the Institute for Supply Management (ISM) stood at 58.7, indicating strong manufacturing growth for the 27th consecutive month. The unemployment rate in May was 3.8% — less than half its peak in 2009, and the lowest rate since 1969.

We believe inflation has the potential to accelerate beyond target and that the Fed, at least initially, will "accommodate" this. In addition to the low unemployment and strong manufacturing Powell cited, other inflationary factors may be building as well. These include the spending boost from the $1.3 trillion federal budget, the tax cut, a deregulatory push by the Trump administration and even tariff increases accompanying a trade war. (The initial trade war skirmishes resulted in a flight to safety that pushed Treasury yields lower. However, the longer-term impact, in our view, could be inflationary.)

Against this backdrop, investors still appear to be expecting a scenario of low-inflationary growth.Since the end of 2017 through June 29, the nominal rate on the 10-year U.S. Treasury has increased by 45 bps, while the break-even rate on the 10-year TIPS (a measure of inflationary expectations) has grown by just 15 bps. In other words, real rates have increased by 30 bps – the majority of the observed growth in the nominal rate.

Exhibit A

The flattening yield curve is coming close to inversion.



Source: U.S. Federal Reserve Bank of St. Louis, as of June 30, 2018.

A tough half year for bonds

Rising nominal rates in 2018 have taken their toll on total return in fixed-income sectors. In Exhibit B, returns in most fixed income sectors in 2017 exceeded those in U.S. Treasuries as investors' search for yield drove up risky sectors. In particular, nondollar sectors like emerging-markets local currency and the global agg ex-U.S., benefited from a 7.8% decline of the U.S. dollar against a broad basket of currency, and posted double-digit gains.

This year has been markedly different. In February, the U.S. dollar began to strengthen in response to rising rates, sparking a sell-off in local emerging markets debt, and the sector declined more than 10% in the second quarter.

Exhibit B

Rising rates are taking their toll on most fixed-income sectors.

Total return (%)

2017	1Q18	2Q18	YTD through 6/30
EM (Local Currency) 15.21	EM (Local Currency) 4.44	High Yield 1.00	Bank Loan 2.16
Global Agg Ex-U.S. 10.51	Global Agg Ex-U.S. 3.62	Municipal 0.87	High Yield 0.08
High Yield 7.48	Bank Loan 1.45	Bank Loan 0.70	Municipal -0.25
Investment Grade 6.42	High Yield -0.91	MBS 0.24	MBS -0.95
Municipal 5.45	Municipal -1.11	Treasury 0.10	Treasury -1.08
Bank Loan 4.12	Treasury -1.18	Investment Grade -0.98	Global Agg Ex-U.S. -1.31
MBS 2.47	MBS -1.19	Global Agg Ex-U.S. -4.76	Investment Grade -3.27
Treasury 2.31	Investment Grade -2.32	EM (Local Currency) -10.42	EM (Local Currency) -6.44

Source: Morningstar, Inc., as of June 30, 2018. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for important additional information. Investment Grade represented by Bloomberg Barclays U.S. Corporate Index. MBS represented by Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index. Treasury represented by Bloomberg Barclays U.S. Treasury Index. High Yield represented by ICE BofA/Merrill Lynch U.S. High Yield Master II Index. Municipal represented by Bloomberg Barclays Municipal Bond Index. Bank Loan represented by S&P/LSTA Leveraged Loan Index. Global Agg Ex USD represented by Bloomberg Barclays Global Aggregate Ex-USD Index. EM(Local Currency) represented by JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified. It is not possible to invest directly in an index.

U.S. fixed-income sectors have been hurt as well — only floating-rate loans and high-yield bonds have a positive total return year-to-date through June 29. The negative 1.08% return on the Bloomberg Barclays U.S. Treasury Index highlights the duration embedded in longer-term bonds. It's a reminder that after more than three decades of broadly declining interest rates, in which duration added to total return, the reverse is also true: Duration becomes a negative factor when rates rise.

The case for floating-rate investments

In this environment, I believe it is useful to outline a segment of the bond market whose principal is relatively insulated from the impact of rising rates: floating-rate investments with zero, or near-zero, duration. Exhibit C shows a representative sampling of recent floating-rate issues at differing credit quality levels.

Floating-rate loans are a good example. They are typically offered at a spread above Libor, so a loan's payout will increase as that benchmark does. Loans are below-investment-grade instruments, but they have an unusual combination of credit support features: They are senior in the capital structure and secured by corporate assets. Defaults have amounted to about 2% of principal over 20 years, but the credit support structures have led to recovery rates averaging 80%, according to Moody's Investors Service. Thus, net losses have averaged less than 1%. Many investors have found the yield on loans and near-zero duration an attractive combination.

Tax-exempt floating-rate instruments

Nevertheless, for investors who are more comfortable with higher-quality issues, especially in the later stages of the credit cycle, there are a variety of floating-rate instruments along the credit spectrum (Exhibit C).

Two high-quality examples include municipal floating-rate notes (FRNs) and variable-rate demand obligations (VRDOs)[1]. Like fixed-rate munis, both are exempt from federal taxes and offered by municipal issuers seeking to fund a variety of projects. Typically, their rates are re-set each week based on the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index. The vast majority of the combined $229 billion market is rated investment grade.

Securitized floaters

Floating-rate structured products offer another way to protect against rising rates, and yields and credit quality may be chosen to accommodate one's risk preference. All structured finance shares a common basic element — a pool of securities whose cash flow is carved up to create

[1]About 95% of the market for VRDOs and FRNs is rated investment grade.

a new set of bonds, or "tranches," in a senior/subordinate arrangement. Buyers of the junior tranches receive a greater yield in return for accepting more risk, such as defaults on some of the underlying securities.

The biggest structured finance market involves residential real estate, backed by securities of the two big government agencies, Fannie Mae and Freddie Mac. For example, at the high-quality end of the spectrum, consider Freddie Mac guaranteed collateralized mortgage obligations (CMOs), which are floating-rate notes that pay a spread over Libor. With the flattening of the yield curve, these floaters recently traded at a yield higher than the 10-year U.S. Treasury, with no duration risk. Credit risk is near zero, as Freddie is viewed as having the implied support of the U.S. Treasury.

Freddie and Fannie also have a presence in higher-yielding, lower-quality floating-rate debt through Credit Risk Transfer (CRT) bonds. In the senior/subordinate structure of tranches described above, CRT bonds comprise the most junior tranches (also referred to as residuals, or equity), and are not guaranteed by the issuing agency. The top-rated CRT tranches typically are at the lowest investment-grade rung; the others are below investment grade, or nonrated.

From a macroeconomic perspective, we are relatively bullish on bonds backed by residential real estate. While many individuals were overleveraged going into the last financial crisis, the opposite has been true since then: Individual balance sheets generally are sounder than corporate or government balance sheets. This works in favor of securitized investments backed by home loans and other consumer credit.

Floating-rate loans are also packaged in securitized structures known as collateralized loan obligations, or CLOs. CLOs demonstrate one of the advantages of securitized structures: the ability to offer investment-grade debt backed by a pool of below-investment-grade loans. That's because the junior tranches of the CLO serve as a credit cushion for the senior ones, absorbing losses before the senior tranches experience any. For example, a recent Baa3/Nonrated CLO tranche was offered at 315 bps over Libor, which was 234 bps at the time. That tranche was supported by the lowest-priority tranche of the CLO, which yielded 590 bps over Libor, and was rated Ba3/Nonrated. The lower-rated tranches offer more yield, and may be an attractive investment if you have a positive view on credit.

Exhibit C

Floating-rate assets are offered at yields reflecting the full spectrum of credit quality.

	Rating	Index (bps)	Spread (bps)	Total (bps)	Taxable-equivalent yield (bps)
Municipal VRDO	VMIG1	150 (SIFMA)	0	150	238
Municipal FRN	AA+	150 (SIFMA)	35	185	294
Municipal FRN	A	250 (SIFMA)	50	200	317
Agency CMO	AAA	209 (1-Mo. Libor)	30	239	238
Investment-Grade Bank Floating-Rate Note	A-	234 (3-Mo. Libor)	90	324	324
Private Single-Family Residential CMO	BBB-	209 (1-Mo. Libor)	200	409	408
Structured CRT	B+	209 (1-Mo. Libor)	225	434	433
Private Floating-Rate Loan	BB/BB-	234 (3-Mo. Libor)	232	466	466
Private Floating-Rate Loan	B+/B	234 (3-Mo. Libor)	379	613	613
Private CLO Class D	Baa3/NR	234 (3-Mo. Libor)	315	549	548
Private CLO Class E	Ba3/NR	234 (3-Mo. Libor)	590	824	824

Source: Eaton Vance, June 30, 2018. Taxable-equivalent yield assumes a maximum federal tax bracket of 37%. Credit ratings are categorized using S&P and/or Moody's Ratings, which are subject to change. Credit ratings measure the quality of a bond based on the issuer's creditworthiness, with ratings ranging from AAA, being the highest, to D, being the lowest based on S&P's measures. Ratings of BBB- or higher by S&P are considered to be investment-grade quality. For Moody's, the highest rating is Aaa and the lowest is C; Ratings of Baa3 or higher considered investment grade. VMIG1 is a Moody's short-term rating denoting the highest credit quality. Credit ratings are based largely on the ratings agency's analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer's current financial condition and does not necessarily reflect its assessment of the volatility of a security's market value or of the liquidity of an investment in the security. Holdings may be designated Nonrated (NR) by either S&P or Moody's. SIFMA refers to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, a common benchmark for floating-rate municipal issues. Libor, or London Interbank Offered Rate, is a common benchmark for floating-rate taxable and tax-exempt issues.

What is the curve telling us?

Given that yield curve inversions have preceded the last five recessions by an average of 17 months, it is worth considering how this history relates to today's market, so I close with a few (related) observations:

- **The curve hasn't inverted (yet)** — As Exhibit A shows, the market went through long stretches in the 1980s and 1990s where the spread narrowed, but did not invert. Given the forces in today's economy, it is not a "slam dunk" that it will do so in the near future.
- **This time might be different** — Historically, falling long-term Treasury rates have reflected pessimism about the future economy. Today, however, we see a number of economic signs in the U.S., discussed earlier, that suggest inflationary, upward pressure on long-term rates. At the same time, uncertainty about global politics and trade provide a counterbalancing force: Yields remain low worldwide, and global investors are still attracted to a 2.9% U.S. Treasury yield.
- **Staying short makes sense** — We believe there is greater clarity about the direction of short term U.S. rates than long-term U.S. rates. In addition, we observe there is not much of a yield pickup from investing in longer duration assets. Investors can take advantage of both of these factors by including various floating-rate assets in their investment portfolios, and they can do so across the credit spectrum.

Index Definitions

Bloomberg Barclays Aggregate Bond Ex USD Index is an unmanaged index of investment-grade bonds, including corporate, government and mortgage-backed securities issued outside the U.S.

Bloomberg Barclays U.S. Treasury Index is an unmanaged index of U.S. Treasury securities, and a component of the Bloomberg Barclays U.S. Aggregate Bond Index.

Bloomberg Barclays U.S. Corporate Investment-Grade BBB Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Bloomberg Barclays U.S. Aggregate Bond Index.

Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index measures agency mortgage-backed pass-through securities issued by GNMA, FNMA and FHLMC.

ICE BofA/Merrill Lynch U.S. High Yield Master II Index measures USD-denominated, noninvestment-grade corporate securities.

Bloomberg Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Bloomberg Barclays Global Aggregate Ex-USD Index is a broad-based measure of global investment-grade fixed-rate debt investments, excluding USD-denominated debt.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local currency bonds with maturities of more than one year issued by emerging-market governments.

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