Principal Global PERSPECTIVES

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Principal Global Investors

THE FED RATE RISE

After exactly seven years, the Federal Reserve (Fed) finally decided to raise rates at their December meeting. In the moments following the meeting, we asked experts from across the boutiques of Principal Global Investors for their initial reactions about the impact a rate increase may have on their asset classes.

WITHIN YOUR ASSET CLASS, WHAT STRATEGY OR STRATEGIES WILL FEEL THE BIGGEST IMPACT FROM A RATE HIKE?

Mustafa Sagun, CIO,
Principal Global Equities

We do not believe it will pay off to position portfolios aggressively to benefit from a U.S. "liftoff," especially when that liftoff looks to have happened already!

Higher short-term rates will impact rate-sensitive equities, such as REITs, and high-dividend-paying stocks that have low earnings-growth rates, such as utilities. That said, utilities have already been underperforming, reflecting the market's expectation for the rate hike. Expensive defensive stocks and other rate-sensitive areas should also be avoided. Risk for emerging-market countries remains high, particularly those with current account deficits (e.g., Brazil and Indonesia) if capital flows out of those countries.

As always, we continue to focus on bottom-up stock picking and find companies with sustainable earnings growth, irrespective of early or late cycle earnings beneficiaries.

Shane Johnston,
Senior Portfolio Manager,
Morley Financial Services

As the Fed begins tightening monetary policy, the ability to reinvest at higher yields will have a positive impact on stable value funds' crediting rates in the near term, while the loss associated with the higher rates will be smoothed out over time.

The goal of stable value is to offer investors preservation of capital while providing competitive, positive returns. To achieve these objectives, stable value funds comprise two components, a short-to-intermediate underlying fixed income portfolio and stable value investment contracts known as "wrap contracts."

As with other fixed income vehicles, rising interest rates will have a negative effect on the absolute return of the fixed income portion of the stable value portfolio. However, wrap contracts are designed to help investors achieve positive performance when other fixed income vehicles might be experiencing negative performance. Wrap contracts allow participants to transact at book value (principal plus interest). This accounting methodology allows a fund to amortize market value gains and losses over time through the fund's crediting rate, thus providing capital preservation. Therefore, stable value funds are expected to track interest rates while smoothing out the market value volatility of the fixed income portfolio.

Phil Jacoby, CIO,
Spectrum Asset Management

The federal funds rate increase was done for the right reasons – basically, because of improved labor market conditions, expanding domestic spending and rising inflation expectations. Importantly, the Fed emphasized that "transitory factors" pressing inflation below its 2% objective should abate over time and that future rate increases should be gradual.

The longer-run neutral fed-funds rate is closer to 3.25%, which is forecasted to be achieved within three years (by 2019). This is a constructive playbook for hybrid preferred securities that have fixed-to-floating structures, such as perpetual U.S. bank preferred stocks. Basically, if the rate's path higher plays through as forecasted, the floating-rate dividends of resetting issues should be about 150 basis points (0.15%) higher than the current fixed-rate dividends that prevail today. Another sector that should benefit is the fixed-to-variable structure of non-U.S. banks that reset fixed payments off of the five-year swaps curve every five years. Here, rising rates should benefit income because these structures can follow rates higher by adjusting the coupons higher (which preserves capital too). Indeed, the hybrid market has defensive elements that may finally shine bright now that the Fed engaged its long awaited liftoff.

Chris Carter, Partner,
Origin Investment Management

Although as a firm Origin neither makes nor utilizes macroeconomic or interest rate forecasts, we recently commented that we hoped that the Fed would just get on with it, and speculated that markets would more likely take it better than worse (it hardly being a surprise). We also feel that investors could then get back to focusing on underlying fundamentals at the individual company level. In the medium term, modestly rising interest rates should not pose a threat to the highly profitable and fast-growing companies on which we focus in both developed and emerging markets. Such companies, so long as valuations remain reasonable, should be able to continue to outperform the average company through such a cycle.

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Investing involves risk, including possible loss of principal. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Investing in REITs involves special risks, including interest rate fluctuation, credit risks, and liquidity risks, including interest conditions on real estate values and occupancy rates. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards. Risk is magnified in emerging markets, which may lack established legal, political, business or social structures to support securities markets.

Stable value funds are structured in various ways, but in general they are composed of high quality, diversified fixed income portfolios that are protected against interest rate volatility by contracts from banks and insurance companies. While stable value is generally considered a conservative investment option, stable value assets do carry potential risks. Stable value funds may lose value and may be worth more or less than the original cost when redeemed, and there is no assurance that the fund's objective will be achieved. Risks include, but are not limited to, 1) Investment Contract risk which includes the risk of maintaining Book Value Accounting standards and the risk that Investment Contract issuers may default on their obligations under the contract; 2) interest rate risk which includes the potential that an increase in market interest rates may decrease the value of fixed income securities (bonds); 3) credit risk which reflects the potential that the issuer of fixed income securities will be unable to make the required payments of interest and/or principal when due.

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