Credit Impact of a Fed Tightening Cycle

Perspectives

September, 2014

As fixed income investors increasingly focus on the Federal Reserve's (Fed) unwinding of its zero-interest rate policy (ZIRP), we thought it would be informative to examine the previous Fed tightening cycle in 2004-2006. We examined the potential catalyst for tightening, its impact on the investment grade credit market and highlight several investment implications. We focused specifically on the 1-5 Year corporate sector as it significantly benefited under the ZIRP regime and is potentially the most vulnerable under rate normalization.

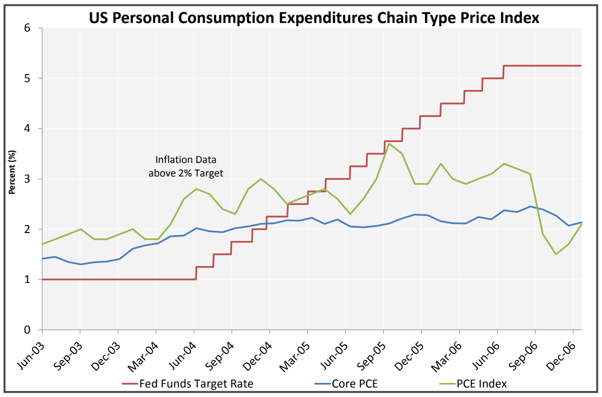
Dan Kang, CFA
Sr. Research Analyst

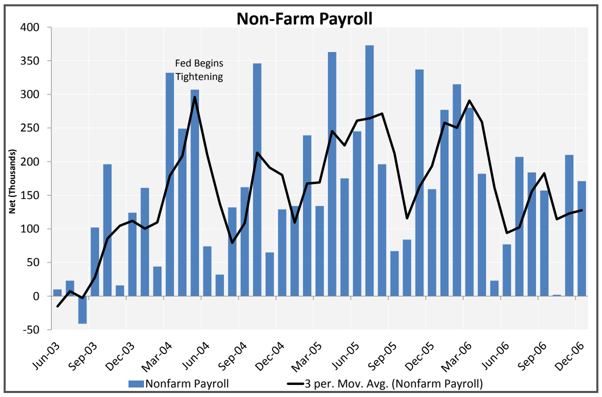
Key Summary:

- The Fed tightening cycle should not necessarily be feared.
- After the initial shock of an imminent hike, total and excess returns over Treasuries for investment grade credits for the one year period ending June 30, 2005 were 3.28% and 0.62%, respectively.
- After the market acclimated to a rate hike, relative performance differentiation was due to credit-specific factors.

Potential Catalyst:

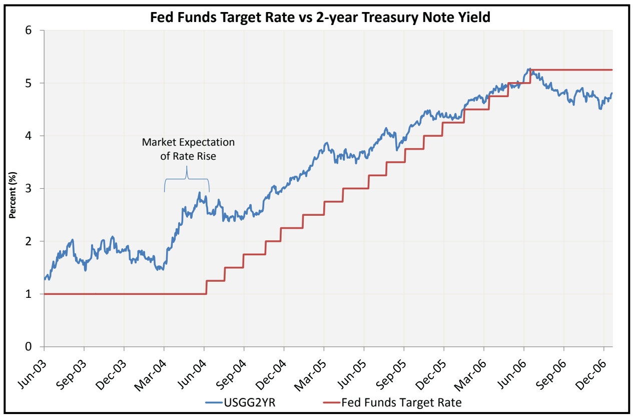
Prior to the first rate hike, the markets and policy makers saw a meaningful increase in both employment and inflation. The average of the three months prior to the hike for net changes to non-farm payrolls was 296K and the unemployment rate dropped from a peak of 6.3% in June 2003 to 5.6% immediately before the June 2004 Federal Open Market Committee (FOMC) meeting. Interestingly, the monthly employment data was highly volatile throughout the tightening cycle with monthly changes ranging from 23K to 373K . The Personal Consumption Expenditure (PCE) price index crept past 2% inflation and stayed above the implied inflation target throughout the tightening cycle.

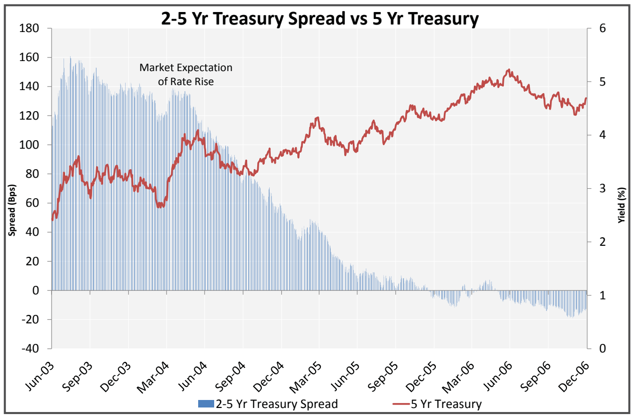




Examination of the 2004-2006 Fed Tightening Cycle:

The Fed started its tightening policy at its FOMC June 29, 2004 meeting, but markets anticipated the tightening policy approximately three months prior to the initial rate hike. As a result, the 2 Year Treasury yield spiked approximately 150 bps over that same period. Over the next two years, the FOMC proceeded to raise the federal funds target rate by 25 bps at each meeting. As expected, the 5 Year Treasury yield increased over the tightening cycle reaching a high of 5.2% from a low of 2.64%. After an initial steepening, the 2 Yr–5 Yr spread collapsed dramatically from approximately 125 bps to a low of -19 bps.





Credit Market Impact:

We examine the credit market performance in three periods:

- Phase 1: The one year period before the actual tightening (June 2003-June 2004).
- Phase 2: The three month sub-period immediately prior to an imminent Fed action (April 2004-June 2004). The market anticipated a change in Fed policy as data came in stronger than expected.
- Phase 3: The one year period after the initial tightening (June 2004-June 2005). The Fed raised the Target Rate 25 bps at each meeting for a total increase of 225 bps.

During Phase 1, corporate bonds performed extremely well as the economy recovered from the tech bust of 2001, 9/11, and the Iraq invasion of March 2003. During Phase 1, the Barclays 1-5 Year Corporate Index total and excess returns over duration-matched Treasuries were 1.39% and 1.49%, respectively. This period included Phase 2, the three month period of volatility as the market anticipated the change in the Fed's accommodative policy.

As expected from a recovery phase, cyclical higher-beta credits outperformed. Overall, BBB-rated bonds outperformed significantly and subsectors weighted toward BBB-rated bonds benefited. In Phase 2, both rates and spreads traded off as the three month period exhibited a total return of -1.77% and a mild excess return over Treasuries of -.02%. BBB-rated bonds were the only quality bucket that exhibited positive excess returns during this volatile adjustment period.

April 2004 - June 2004

Quality	Mean Monthly Return	Standard Deviation	Mean Monthly Excess Return	Standard Deviation	Total Return	Total Excess Return
Baa	-0.4867	0.8587	0.0700	0.1652	-0.0400	0.0600
Total	-0.5933	0.9458	-0.0100	0.1253	-0.1300	-0.0200
Aaa	-0.6633	1.0481	-0.0533	0.1159	-0.1500	-0.0300
Aa	-0.6133	0.9544	-0.0500	0.1044	-0.1600	-0.0500
A	-0.6567	1.0083	-0.0500	0.1179	-0.1900	-0.0800

A review of the Phase 2 best and worst performing subsectors produced several observations:

- Financials were a highly liquid and relatively rich subsector and underperformed irrespective of credit quality.
  - Banking, Financial Companies, REIT's and Brokers all underperformed the index.
  - Fundamental concerns of bank performance in a rising rate environment contributed to underperformance.
- Automotive, the largest outperforming subsector, benefited from credit-specific news.
  - Ford, the largest component of the index, had significantly better than expected first quarter earnings in 2004 and continued to reduce its debt profile.
- Other underperforming subsectors had credit-specific factors that impacted performance.
  - Tobacco had a negative legal ruling during the time period.
  - Gaming had swirling merger rumors.
  - Airlines were impacted by rising energy prices.

Barclays 1-5 Year Corporate Index

March 31, 2004 - June 30, 2004 (Phase 2)

Best Performing Sectors	**OAS**	**Excess Return**	**Worst Performing Sectors**	**OAS**	**Excess Return**
Automotive	150	0.84%	Restaurants	50	-0.15%
Consumer Cyc Services	78	0.60%	Non-Captive Diversified	52	-0.15%
Paper	87	0.28%	Wirelines	83	-0.16%
Transportation Services	198	0.28%	Chemicals	76	-0.18%
Supermarkets	84	0.26%	Brokerage Assetmanagers Exchanges	54	-0.21%
Oil Field Services	70	0.19%	Non-Captive Consumer	60	-0.21%
Cable Satellite	82	0.19%	Tobacco	151	-0.23%
P&C	82	0.18%	Banking	48	-0.24%
Packaging	69	0.16%	Gaming	127	-0.42%
Home Construction	95	0.13%	Airlines	315	-1.47%

Interestingly, several of the best/worst performing sectors in Phase 2 reversed during Phase 3. The Automotive subsector in particular saw significant underperformance as falling automobile sales, rising commodity prices and failing suppliers weighed on the subsector. Cable companies and Transportation Services consistently performed well during both Phase 2 and Phase 3.

Barclays 1-5 Year Corporate Index

June 30, 2004 - June 30, 2005 (Phase 3)

	Best Performing Sectors	**Excess Return**		**Worst Performing Sectors**	**Excess Return**
(1)	Airlines	6.17%		Consumer Products	0.56%
(1)	Gaming	3.33%		Wireless	0.55%
(1)	Tobacco	3.18%		Restaurants	0.49%
	Cable Satellite	1.73%		Media Entertainment	0.47%
	Transportation Services	1.54%	(2)	Paper	0.46%
	Other Industrial	1.36%		Textile	0.45%
(1)	Chemicals	1.32%	(2)	Consumer Cyc Services	0.43%
	Railroads	1.32%		Pharmaceuticals	0.18%
	Lodging	1.31%	(2)	Packaging	0.04%
	Home Construction	1.25%	(2)	Automotive	-2.91%

(1) Phase 2 Worst Performing Sectors
(2) Phase 2 Best Performing Sectors

Lessons From The Prior Fed Hike:

- **Do not take credit risk off pre-maturely.** Phase 1 produced excess returns of 1.49%. Only when policy change was imminent did corporates experience mild negative excess returns as seen in Phase 2.
- **Rich and liquid trading sectors should underperform during a sell-off.** As expected, when investors begin exiting positions they look toward highly liquid subsectors. As noted above, Financials were highly liquid and relatively rich. Today, we suspect underperformance will be led by large cap Tech/Telecom issuers who have recently issued multi-billion dollar tranches and trade tight to the underlying indexes.
- **Alpha can be generated from issue selection.** Even during Phase 2, there were subsectors that generated positive excess returns. Further, we note that a strategy of purchasing the worst performing sectors during the initial sell-off would have produced the biggest returns over Phase 3.

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