U.S. Fixed Income: Potential Interest Rate Shock Scenario

Executive Summary

Income-oriented investors have become accustomed to an environment of consistently low interest rates. Yields on the benchmark 10-year Treasury note have remained below 4% since the summer of 2008 and have not even reached as high as 6% for more than a decade.

Our view is that traditional recovery market dynamics are not likely to inform how interest rates move over the next few years. Rather, we anticipate that U.S. rates will remain relatively low while experiencing gradual increases during the next couple of years. However, we also anticipate that an interest rate shock is becoming increasingly likely during the next three to five years based on the deteriorating financial conditions of the U.S. government.

Investors may want to prepare for a scenario where interest rates move significantly higher.

While future events are impossible to predict, investors, particularly those focused on generating a stream of income from their investments, need to be prepared to protect their portfolio from potential changes in the environment for U.S. Treasury securities.

What typically moves interest rates?

Three factors tend to have the most impact on the "fair value" of bond yields. They include:

- Interest rates on U.S. Treasury bills which reflect rates based on the current Fed Funds Target Rate and are typically considered to be the least risky investment available to U.S. investors
- Estimates of the expected inflation rate not just in the near term, but over the intermediate to long term
- A default premium based on an assessment of the quality of the bond issuer

We are now more than two years into an economic recovery. The consensus view currently held by many investors appears to be that inflation is an immediate risk and interest rates may be forced higher. However, we believe inflation and interest rates are likely to be modest over the next two to three years. We have reached this opinion based on the current moderate levels of inflation, the anticipated future inflation rates as indicated by forward

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pricing on Treasury Inflation-Protected Securities (TIPS), and forward prices on Treasury bonds. With respect to default premiums, the U.S. has historically been viewed as a safe harbor for bond investments. If world market investors were to reassess their opinions and begin to question the safety and risk-free nature of U.S. Treasury securities, it could lead to an interest rate shock scenario.

Limited short-term risk for bonds

The question now is whether traditional market dynamics will drive interest rates higher in the coming years. The historically normal pattern can best be described as a chain reaction:

- During the initial period following the end of a recession, the economy tends to grow faster than normal, creating a "catch up" period in light of the economic output lost during the recession.
- While monetary policy tends to be accommodative in recovery phases, the typically robust economy following recessions tend to be characterized by businesses and individuals borrowing in order to take advantage of economic growth.
- As borrowing picks up, this demand on capital, along with typical increases in demand for all other resources (labor, real estate, commodities, etc.) results in interest rates being forced up and overall inflation rises.

In this post "Great Recession of 2007-2009" recovery period, the U.S. economy is growing, but at a modest rate. Businesses and individuals are borrowing, but are primarily looking to fund day-to-day needs rather than funding expansion. The Federal Reserve is maintaining a very accommodative monetary policy in order to try to stimulate expansionary demand.

Unfortunately, we do not expect economic growth to heat up over the next couple of years due to multiple headwinds including deleveraging, the aftermath of the real estate bubble, and pervasive business and consumer uncertainty. Without a faster economy on the horizon, we do not anticipate higher rates from a demand for capital, at least not from the private sector.

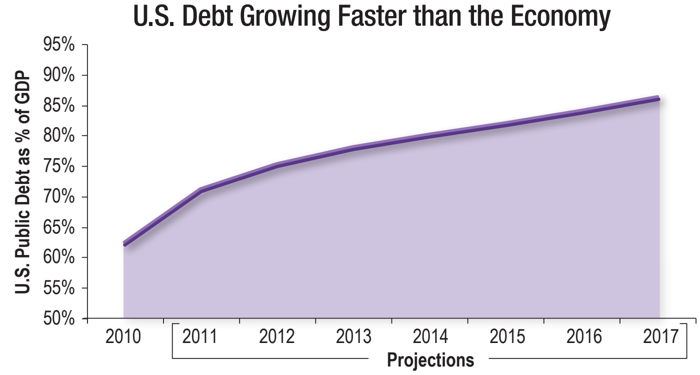
Similarly, we do not anticipate that broad based inflation will build enough to drive rates higher. The majority of Consumer Price Index (CPI) components involve the cost of labor (wage rates) and the cost of housing. Wages are not likely to rise broadly during the next few years because of persistently weak employment conditions. Housing costs are not likely to rise in the next few years during the aftermath of the real estate bubble burst period and resolution.

Long-term issues facing fixed income markets

Of greater concern, in our opinion, is the risk of interest rates rising suddenly and unexpectedly due to global market concerns regarding the financial condition of the U.S. government. Net outstanding U.S. debt is currently equivalent to approximately 65% of the annual output of the U.S. economy and growing rapidly. Under current estimates:

- During the 2011 fiscal year, the projected budget deficit for the year (which will add to the total debt) is over 10% of U.S. Gross Domestic Product (GDP).
- In the 2012 fiscal year, forecasts suggest the cumulative debt load for the federal government will increase by a level equivalent to an additional 7% of U.S. GDP.
- Longer-term projections indicate that the U.S. will experience significant budget deficits and an expanding debt load every year for at least the next ten years.

U.S. Debt Growing Faster than the Economy



Source: Congressional Budget Office (CBO) for 2010 data; Projection analysis prepared by U.S. Bank Asset Management Group by utilizing information and research data obtained from the 2011 U.S. Federal Budget.

Congress and the administration appear to just be starting the process of making the difficult decisions required to materially alter the projected outcomes described earlier. In light of the financial condition of the U.S., and with no current plans in place to rectify the situation, the credit rating firm Standard & Poor's recently assigned a negative outlook to U.S. Treasury bonds. A negative outlook from a major credit rating agency indicates that unless conditions improve, the credit worthiness of the entity is on a negative trend and there is a one in three chance of a rating downgrade in the next three years. A credit rating downgrade typically results in interest rates rising and bond values falling. Rating agencies tend to be followers compared to the market. However, conclusions drawn by rating agencies tend to reflect the existing sentiment of major investors.

It is important to note that even with the negative financial condition and trends for the U.S. budget deficit, Treasury bond yields have not reflected particular anxiety from investors. We believe this lack of concern indicates that the global market still perceives U.S. Treasury securities as one of the safest credits in the world. However, as time goes by, if the financial condition of the U.S. government continues to deteriorate, we anticipate a significantly negative market reaction could occur. Ultimately, major purchasers of U.S. Treasury securities may demand higher interest rates to compensate for the perceived risk of their investment.

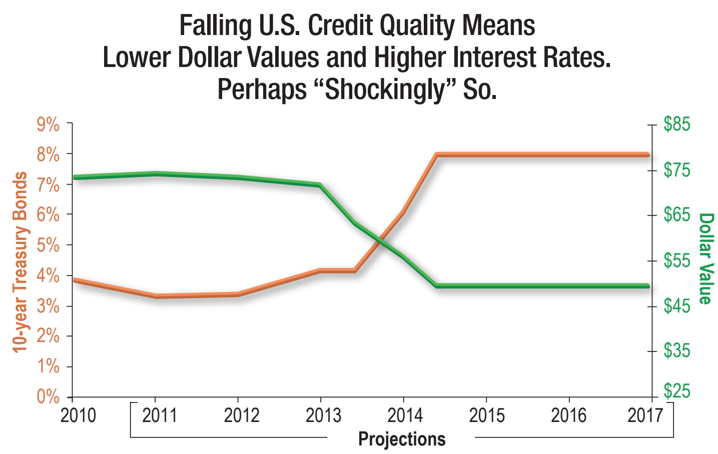
In our opinion, investors are not likely to be concerned by an actual default by the U.S. government. Rather, investors may anticipate declining values in Treasury bonds and require higher yields to offset potentially higher risks.

Warning signs of an interest rate "shock"

The interest rate shock scenario we are describing may initially play out as an impact on the U.S. dollar instead of directly on interest rates. Historically, when geo-political crises have occurred that have an impact on the global economy, investors worldwide have tended to shift capital towards potentially safe investments like U.S. Treasury bonds and the U.S. dollar.

During 2010 and so far in 2011, the dollar has fallen relative to other major currencies. It is notable that when historic events such as uprisings in the Middle East and the natural disasters in Japan occurred in recent months, Treasury bond rates fell as capital flowed in, but the value of the U.S. dollar languished. We view this as a sign that while world investors appear to continue to have faith in the potential safety of U.S. debt, they feel differently about the viability of the dollar's value.

We sense that as the financial condition of the U.S. government weakens, the dollar will be under increasing pressure. At some point, if global capital markets lose confidence in the ability of the U.S. to rein in budget deficits, the dollar could drop precipitously. If this happens, interest rates on U.S. Treasury securities could dramatically increase. This type of shock scenario is illustrated in the following chart.



Source: FactSet for 2010 data; U.S. dollar represented by trade weighted dollar index; Projections prepared by U.S. Bank Asset Management Group based on internal analysis of probability assumptions.

How soon could this risk scenario develop? We believe the odds of an interest rate shock scenario occurring may remain low for the next two to three years. It is our opinion that moderate interest rates will likely continue to placate investors of U.S. Treasury securities at least through the 2012 presidential election cycle. This acceptance may even extend for a short period afterwards, perhaps an additional year, as world markets wait to see what the newly elected administration would do relative to enacting fiscal policy changes. However, it is not likely that bond investors will be willing to hold off very long before demanding higher interest rates. As a result, if the U.S. financial condition is not quickly and significantly improved, we believe an interest rate shock scenario could occur within two years following the election.

Investors should prepare to protect their portfolio from potential changes in the interest rate environment.

Conclusion

Our view is that the current global comfort with U.S. Treasuries as a potentially safe investment may be surprisingly persistent, with interest rates remaining relatively low for two to three years. Unfortunately, while U.S. interest rates remain low, there is less pressure on the U.S. government to address the hard decisions required to resolve our financial distress. Without real pressure, it seems unlikely that Washington will risk voter ire by cutting spending or by raising taxes significantly.

During the next couple of years, if Washington doesn't invoke strong fiscal measures, the net national debt outstanding may rise significantly from the current 65% of U.S. Gross Domestic Product. The interest payments on the U.S. debt, currently about 15% of total government revenues, may rise towards 20% or more of government revenues in three years or so. It may be this growing debt service obligation, which may increasingly crowd out other government spending, that will be the visible symptom of our financial crisis and that triggers a sell off in the dollar, which may in turn precipitate an unfortunate step up in interest rates.

What should investors do to attempt to defend against this potential risk? In the near term, it is our view that the chance of this scenario harming portfolios is fairly low. Recognizing that most clients are very interested in income, we recommend maintaining defensively underweighted allocations to higher rated municipal bonds or taxable bonds as appropriate for income tax objectives.

During the next two to three years, if this scenario plays out as described, we advise building increasingly larger allocations to hedged debt style managers while gradually reducing core bond exposure. If pressure grows on the U.S. dollar, we recommend that overall portfolio allocation be gradually shifted towards non-U.S. allocations of stocks, bonds and real estate.

This scenario represents a potential risk to portfolios. Clients should note that the possibility of an interest rate shock is just that, a possibility. We in no way are implying that the outcomes described are a certainty. However, these risks are significant enough for us to take them seriously on our clients' behalf.

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