

Full Discretion Team

Extra Credit

Higher interest rates: *risks, drivers & opportunities*

A BETTER BACKDROP FOR BONDS

The bond market appears to be approaching a level we would consider as closer to fair value. Momentum and fear are keeping buyers on the sidelines, but we think stability could return quickly if 1) the Iran War is resolved, or 2) Federal Reserve Chairman Warsh credibly states his inflation fighting credentials by acknowledging he will do what it takes to keep the bond market stable, even if that means raising the policy interest rate.

Bigger picture, we think bond investors are in a good place today. Fixed income portfolios can generate attractive yields without the need to take on unnecessary risk, in our view. Many have memories of the steep losses fixed income portfolios suffered during 2022, but today's bond math makes a repeat of that event unlikely, in our view. Today's fixed income portfolios have a thicker yield cushion that helps to mitigate principal losses that could come about from rising yields.

STRUCTURAL FORCES, ONE DIRECTION: HIGHER INTEREST RATES

The directionality of yields over the past several years is consistent with our structural viewpoints. As a recap, we have identified structural factors in the economy that we believe drive an upward bias to interest rates in both real and inflation adjusted terms. [These structural factors include:](#)

1. **DEMOGRAPHICS:** An aging population coupled with low fertility rates and a crackdown on immigration effectively tightens the pool of available labor while also driving very large entitlement spending (Social Security & Medicare).
2. **SECURITY:** The post-WWII world order is coming unmoored, driving a high degree of concerns and uncertainty at the global geopolitical level. Conflicts have risen and countries seek security through raising defense spending, pursuing trade protectionism, and shoring up supply chains.
3. **INVESTMENT BOOM:** The world has gone from a savings glut to an investment spending boom. Artificial intelligence (AI), energy, and climate spending are driving massive capital expenditures. This boom is boosting both GDP growth rates and equity prices and competing for capital dollars in the financial markets.
4. **FISCAL DEFICIT:** The US government is running a large structural deficit that stimulates economic growth (even with full employment) while also raising the supply of debt that needs to be placed by the US Treasury.

Key Takeaways

- Bonds are approaching more attractive levels with higher starting yields providing income and a stronger cushion against future volatility
- Structural forces are driving a persistent upward bias in interest rates
- Inflation is proving more durable than expected, supported by rising core prices, resilient demand, and supply side pressures like energy shocks
- Rising yields are beginning to test risk assets globally, with the potential to weigh on equities and credit—while also reflecting a broader, global repricing driven by higher inflation and increased spending
- The bond market appears to be testing incoming Federal Reserve (Fed) leadership, challenging assumptions that policy will remain accommodative under Chairman Warsh

This is a starkly different backdrop to what existed during the disinflationary/quantitative easing (QE) years not so long ago. We believe significant spending from both the private and public sectors could drive more competing debt issuance, which could ultimately increase real yields. We are seeing a return to a positive yield curve premium that can compensate investors for supply/demand imbalances and inflation uncertainty.

Not surprisingly, given our structural framework, we believe inflation is in the system and can be seen by the rising cost of living. Inflation is a distorting factor when it becomes unstable, and it can become a key driver of the economic cycle. Rising prices can hit demand as wages fail to keep pace, causing a pullback in consumption and choppier economic activity. Inflation recedes as demand cools only to resurface when consumers catch up and consumption revives. At that point, the economic cycle becomes choppier and uneven. Managing monetary policy also becomes difficult for central banks, especially when inflation results from supply side factors and excessive fiscal spending.

INFLATION ISN'T DONE YET

Cyclically, inflation is starting to creep higher. The Iran War has created an energy supply shock that will likely raise US inflation to more than 4% in the coming months even if the Strait of Hormuz were to open today. The Fed's historical standard play book is to look through an energy supply shock. That would be the appropriate policy today, in our view. However, inflation was already starting to lift off a cyclical low even before the war started. Prices excluding the more volatile food and energy components are hooking back upward. Core services prices (so-called Super Core) have moved above 3% again. Core goods prices are also resilient. Shelter is the one major component that has been disinflating, but it is a lagging item, and we expect it to revert to longer terms trends in the coming twelve months. Meanwhile, the recent worries about the labor market are fading as employment data has surprised to the upside in recent months.

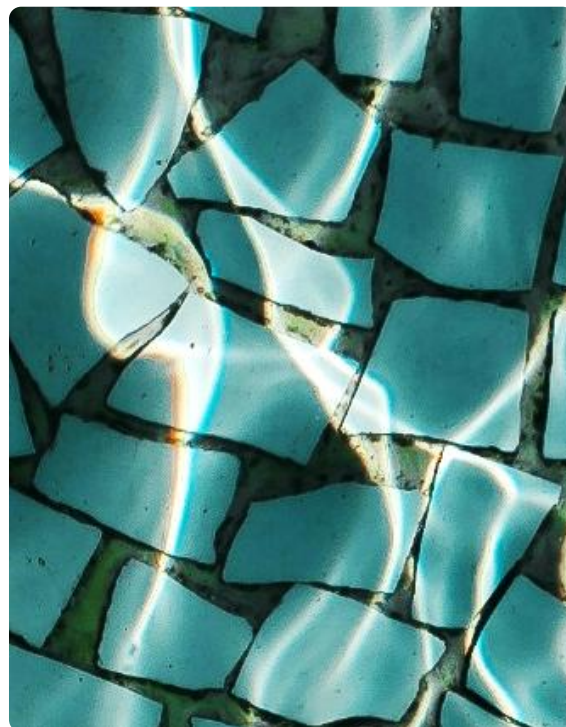
Both the bond market and the Fed are taking notice of the current situation. The bond market is now pricing in one interest rate hike over the next year compared to two cuts just before the Iran War started. The Fed has shifted to a more neutral stance, lessening its concern about the labor markets and elevating its worry over inflation.

In our view, the Fed is in danger of being a bit behind the curve. We estimate that today's appropriate policy interest rate should be closer to 4.25% compared to the current level of 3.75%. We think current levels suggests they are too easy which leaves them vulnerable to the possibility of second round price increases from the energy shock or simply an unraveling of inflation expectations.

RISING YIELDS, RISING STAKES

It is our view that a Fed that is positioned as accommodative while the economy is booming paints a picture of a yield curve that will tend to steepen or at least bear flatten. Thus, we are seeing yields rise across the entire curve. Investors appear spooked by the move in yields and are worried momentum will carry the 10-year US Treasury closer to 5% and the 30-year US Treasury closer to 5.50%. We think higher yields will, at some point, cause problems for the risk trade. Yields moving north of 5% would most likely reduce risk appetite for equities and credit spreads.

To some extent, the bond market might be testing the incoming Fed chairman, Kevin Warsh. As a Trump appointee, there is the view that Warsh will lean towards cutting the policy or at least keeping it steady. We believe the market might be over playing that view. One way for Warsh to get control of the narrative and possibly pull-down yields along the curve is to state his commitment to fighting inflation. Even a good jaw boning around that subject could break the one directional move of yields, possibly allowing buyers to step back in and drive yields a bit lower. It is important to note that global yields are rising in tandem. It is not just a US story. Yields are reaching multi-year and, in some cases, multi-decade highs around the world. The story is the same - rising inflation and massive spending. Higher global yields puts upward pressure on US Treasury yields as the US competes for global sources of deficit funding.



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Diversification does not ensure a profit or guarantee against a loss.

Market conditions are extremely fluid and change frequently.

Any investment that has the possibility for profits also has the possibility of losses, including loss of principal.

There is no guarantee that any investment objective will be realized, or that the strategy will be able to generate any positive or excess returns.

Past performance is no guarantee of future results.

Meet the Team

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About the Team

The Full Discretion team brings decades of expertise and collaboration to create tailored solutions for their clients.

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Investment Professionals

22+Years of Industry Experience
(Portfolio Management Team)**\$85.8**Team Assets Under Management
(Billion USD)

Team Philosophy

We have a legacy of independent thinking and leaning into the market when others may be pulling away. We take a deep-value, equity-like approach to credit selection across global fixed income markets. Our disciplined process helps give us confidence in seeking to identify macro trends, formulate a clear view on market sectors, and invest throughout the credit cycle.

For more than 40 years, we have been applying our distinctive style of bond picking to deliver portfolios designed to provide excess yield potential and have low correlations to traditional benchmark-focused fixed income strategies.