INFLATION AND INTEREST RATES
How do they affect your portfolio?

EAGLE | Asset Management
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CONCERN Over Inflation

Inflation swelled briefly in October, but appears to be slowing on a year-over-year basis. Many investors and analysts are keeping a close eye on inflation in light of recent interest rate activity by the Federal Reserve (Fed).

Current market-based forecasts suggest the Fed appears likely to increase the Fed Funds rate target at its meeting on December 18-19. Here's why it matters to your fixed income portfolio:

- Inflation is the primary driver of interest rate increases. The Fed increases rates to keep inflation in check. Higher expected inflation tends to lead to more interest rate increases.
- Interest rates and the prices on existing bonds are inversely related. Thus, as interest rates increase, the prices on existing bonds decrease.
- Generally speaking, as inflation expectations increase so do bond yields, particularly on the longer end of the curve, as bond investors will demand higher return to compensate for inflation risk.

When you add interest rate increases, volatility in oil prices and uncertainty over trade in China, these factors have resulted in a reduction of inflation expectations.

THE BIG MOVE In Interest Rates

James Camp, CFA, Managing Director of Fixed Income at Eagle Asset Management, believes there is little risk of inflation coming unhinged.

"It's important that clients understand when they worry about interest rates that 'the worst' has already happened," Camp opined during a recent webinar. "Since 2016, we have seen a significant move for interest rates (see Figure 1). Many global sovereign debt yields were negative that year. We believe that would have been the time to panic. From a monetary policy standpoint, things seem to be more normalized now."

FIGURE 1 The Big Move In Interest Rates Has Occurred
Rising rates over 2 years lead to higher bond yields

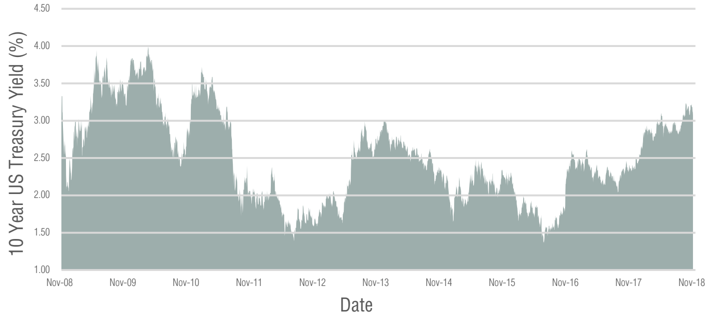
Source: FactSet

Well-anchored inflation appears to be reflected in the actions of central banks. The Fed has stopped its quantitative easing program and embarked on quantitative tightening – the raising of interest rates. Some analysts are concerned that other world banks tightening at the same time could cause a global quantitative tightening cycle, possibly weakening the economy. However, global inflation is low and the likelihood of world banks putting the brakes on monetary accommodation is also low.

A primary concern for Mr. Camp is that the Fed might be overly aggressive in raising interest rates several more times in 2019; however, the possibility of falling inflation suggests to Mr. Camp that the Fed lacks economic or market justification for aggressive hikes in the next year. Market odds are for one to two rate increases in 2019[1], but Mr. Camp is wary of a Fed policy error.

ATTRACTIVE Bond Yields

FIGURE 2 Yields At Highest Level In Seven Years



Source: FactSet

For the time being, the Eagle Asset Management fixed income team is seeing a lessening of inflation expectations. The interest rate environment appears benign for the time being and bond yields are at their highest in seven years (see Figure 2), with future income prospects at historically attractive levels.

[1] Bloomberg

About Eagle Asset Management

Eagle Asset Management, an affiliate of Carillon Tower Advisers, provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

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Many investors consider bonds to be "risk-free" investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Contact us at 800.521.1195 or visit eagleasset.com

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880 Carillon Parkway | St. Petersburg, FL 33716 | E18-1372 | Exp. 01/31/2019