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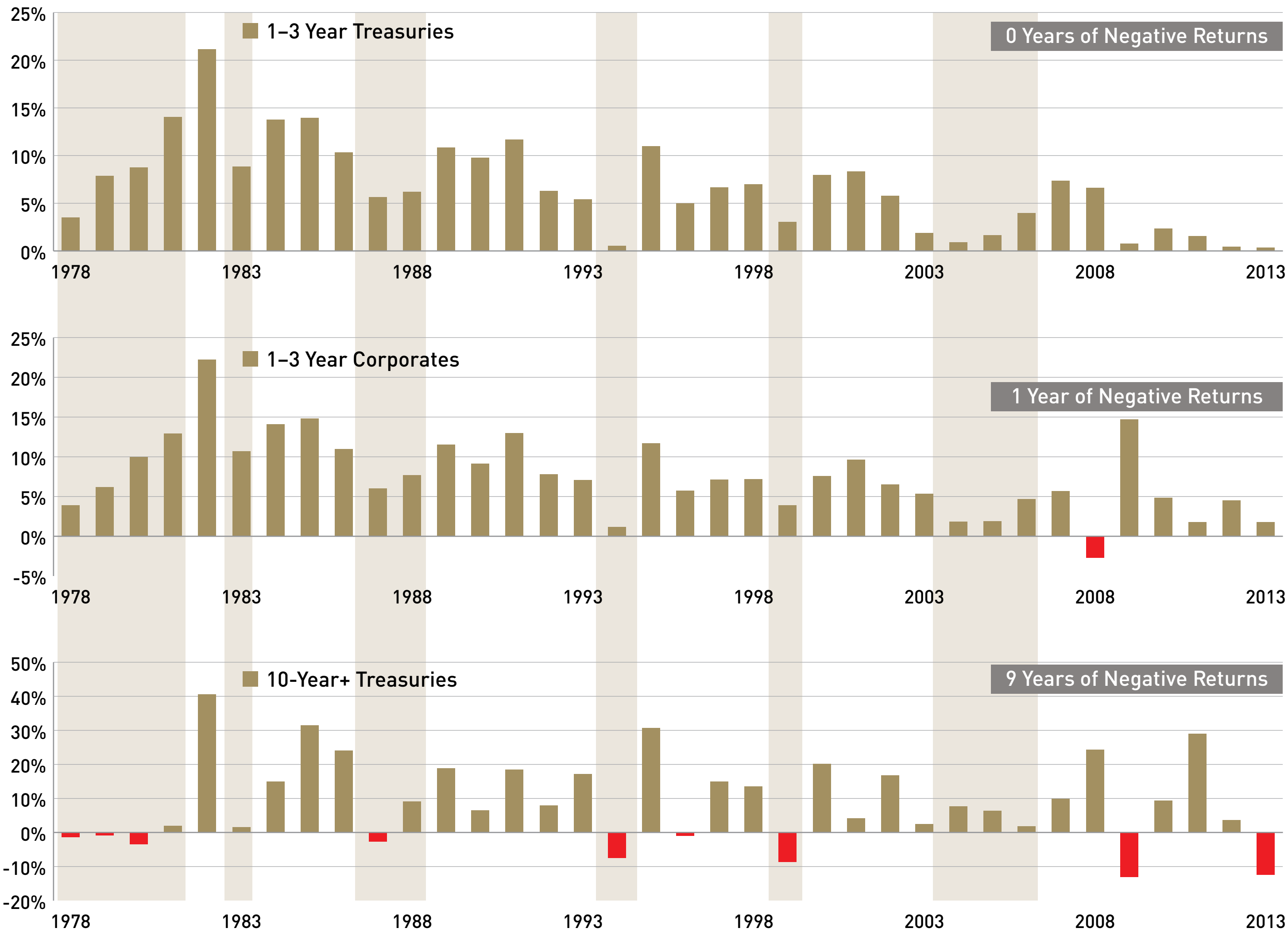
MARKET VIEW

BONDS: SEEKING A HAVEN FROM FED RATE HIKES?

Where can fixed-income investors turn when the Federal Reserve begins to raise the benchmark interest rate? History suggests they should look at the short end of the yield curve.

CHART 1. WHICH MATURITIES HAVE HELD UP THE BEST WHEN THE FED HAS HIKED RATES?

ANNUAL RETURNS FOR INDICATED CATEGORIES OF FIXED-INCOME SECURITIES, 1978–2013



Source: BofA Merrill Lynch. 1–3 Year Treasuries represented by the BofA Merrill Lynch 1-3 Year U.S. Treasury Index; 1–3 Year Corporates represented by the BofA Merrill Lynch 1-3 Year Corporate Index; and 10-Year Plus Treasuries represented by the BofA Merrill Lynch 10+ Year U.S. Treasury Index. Shaded areas represent periods during which the Federal Reserve raised interest rates.

The historical data are for illustrative purposes only, do not represent the performance of any Lord Abbett mutual fund or any particular investment, and are not intended to predict or depict future results. Investors may experience different results. Due to market volatility, the market may not perform in a similar manner in the future. Indexes are unmanaged, do not reflect the deduction or expenses, and are not available for direct investment.

Past performance is no guarantee of future results. The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes.

For many observers, the question is not if but when the Federal Reserve will begin to hike the benchmark fed funds rate. "Progress in employment and gradual increases in inflation suggest at some point" that the Fed will hike interest rates, notes Zane Brown, Lord Abbett Partner and Fixed Income Strategist. Based on a Fed document released June 18, projections from Fed officials indicate that a rate hike would likely come during 2015. Concerns are rising in the bond market that when the Fed does pull the trigger on a rate hike, yields on short-maturity Treasury securities will likely rise, leading to losses in other categories of short-term fixed-income securities, especially corporate debt.

But those fears appear to have little, if any, grounding in recent history. In examining annual return data since 1978 (see Chart 1), for example, short-maturity U.S. Treasury bonds (as represented by the BofA Merrill Lynch 1-3 Year U.S. Treasury Index) have not posted a negative return over a full calendar year. This period includes some extended rough patches for the overall bond market brought about by Fed rate hikes or other adverse developments, most notably the late 1970s, 1987, 1994, 1999, 2004–06, and 2013.

In addition, short-term corporate debt appears to have held up rather well during that time. Short-term corporate debt (as represented by the BofA Merrill Lynch 1–3 Year U.S. Corporate Index) has posted a negative annual return in only one year during the period covered in the chart. That year was 2008, which featured a near-meltdown of the U.S. financial system amid a devastating credit crisis. Indeed, the Fed actually *cut* interest rates that year.

The annual-return data on longer-maturity issues tell a different story when it comes to performance in periods that include Fed rate hikes. Treasury securities with maturities of 10 years or longer (as represented by the BofA Merrill Lynch 10+ Year U.S. Treasury Index) were down in nine full calendar years during the period, including seven that coincided with periods in which the Fed was raising rates.

So which end of the curve really could be the more prudent choice for fixed-income investors if short-term interest rates start to rise when the Fed begins hiking the fed funds rate? Nothing is certain, but history suggests that shorter-maturity issues could weather the storm fairly well. During periods when the Fed raises rates to help slow the economy and reduce inflation, "short-term asset classes have tended to perform relatively well," Brown says. *[Although there is no guarantee that this asset class will perform in a similar manner under similar conditions in the future.]*

IMPORTANT INFORMATION

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. The value of investments in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise, and as interest rates rise, the prices of debt securities tend to fall. Longer-term debt securities are usually more sensitive to interest-rate changes. The longer the maturity date of a security, the greater the effect a change in interest rates is likely to have on its price.

Market forecasts and projections are based on current market conditions and are subject to change without notice. Due to market volatility, the market may not perform in a similar manner in the future. No investing strategy can overcome all market volatility or guarantee future results.

Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit. Income from Treasury securities is exempt from state and local taxes. Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

The BofA Merrill Lynch 1–3 Year U.S. Corporate Index is an unmanaged index composed of U.S. dollar-denominated investment-grade corporate debt securities publicly issued in the U.S. domestic market with between one and three years remaining to final maturity.

The BofA Merrill Lynch 1-3 Year U.S. Treasury Index is a subset of the BofA Merrill Lynch U.S. Treasury Index, including all securities with a remaining term to final maturity less than three years.

The BofA Merrill Lynch 10+ Year U.S. Treasury Index is a subset of the BofA Merrill Lynch U.S. Treasury Index, including all securities with a remaining term to final maturity greater than or equal to 10 years.

Indexes are unmanaged, do not reflect the deduction or expenses, and are not available for direct investment.

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Lord, Abbett & Co. LLC | 90 Hudson Street | Jersey City, NJ 07302-3973 | T 1.888.522.2388 | lordabbett.com

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