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"Bonds and Rising Interest Rates"

"A reliable way to make people believe in falsehoods is frequent repetition, because familiarity is not easily distinguishable from the truth." – Daniel Kahneman

Bonds are in a portfolio for two primary reasons: portfolio stability and income from interest payments. These attributes can usually be a partial hedge against volatility in stocks, which are in a portfolio for growth. A secondary reason for some bonds (usually riskier) in some portfolios is capital appreciation.

Many market participants know the oft-cited mantra that when interest rates rise, the prices of bonds fall. Similarly, when interest rates fall, the prices of bonds rise. However, even though concepts can be stated simply, interest rates and bonds are decidedly not simple.

There are two important points to keep in mind:

> ***Bonds are NOT a monolithic asset class that broadly move together*** (unlike common stocks)
>
> ***Beware of simplistic conclusions about bonds***

To start, there are two major benchmark interest rates in general domestic use that are set by committee and affect key aspects of the broad economy:

> **The Federal Funds Rate**, set by the Federal Open Market Committee (FOMC), is the interest rate at which a bank lends funds maintained at the Federal Reserve (the central bank of the United States) to another bank overnight
>
> **LIBOR** (London Interbank Offered Rate) is a rate that some of the world's leading banks charge each other for short-term loans and serves as the first step to calculating interest rates on various loans throughout the world

There are many thousands of interest rates associated with many areas of the bond market and these are determined in the financial markets. Examples include:

> U.S. Treasuries
> Mortgage Backed Securities (MBS)
> Corporates (Investment Grade)
> Junk (High Yield)
> Municipals
> Non-U.S. Developed Markets
> Non-U.S. Emerging Markets
> Senior Floating Rate Loans

Each of these can be subdivided into numerous segments based on maturity, quality, and terms (callable or non-callable, collateral, sources of payments, frequency of payments, taxable or non-taxable, etc.). ***The many segments of the bond market have their own interest rates that are affected in different ways by changes in the economy, the financial markets, and psychology of market participants***. As a result, interest rates and therefore prices for some segments move to different degrees and often in opposite directions than other segments.

Therefore one must be very careful when discussing interest rates and bonds. Which interest rates? Which bonds?

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Many people in the United States associate the phrase "rising interest rates" with what the Fed is doing with the Federal Funds Rate described above. While it is true that this is a key interest rate, many people make a mistake by coming to a simplistically broad conclusion that all interest rates are rising and therefore it is best to avoid all bonds or at least engage in some special protective strategy to avoid disaster. This is not true!

PIMCO recently published a chart that clearly demonstrates the varied effect on different parts of the bond market during past periods when the Fed was "raising interest rates", or "tightening" in monetary policy parlance. (See Exhibit 1.)

Exhibit 1, Performance During Past Periods of Fed Tightening
Different parts of the bond market had various returns, some positive and some negative, when the Fed increased the Fed Funds Rate

		Performance during past periods of Fed tightening							
Date range	Rate hike (basis points)	U.S. Treasuries	MBS	Investment grade credit	Munis	High yield	Non-U.S. developed	Emerging markets	Senior floating rate
29 March 1988 to 24 Feb 1989	325	3.92%	5.27%	5.21%	7.44%	n/a	4.83%	n/a	n/a
4 February 1994 to 1 Feb 1995	300	-2.69%	-0.49%	-3.93%	-3.56%	-1.74%	-3.55%	-21.70%	n/a
30 June 1999 to 16 May 2000	175	3.27%	2.27%	0.10%	-0.16%	-2.27%	5.07%	14.92%	n/a
30 June 2004 to 29 Jun 2006	425	5.41%	6.80%	5.85%	9.30%	14.88%	9.49%	25.44%	12.38%

As of 30 September 2016.

Source: BofA Merrill Lynch U.S. Treasury Master Index; Barclays U.S. Agency Fixed Rate MBS Index; Barclays U.S. Credit Index; Barclays Municipal Index; Barclays U.S. High Yield 1% Issuer Cap Index; JP Morgan GBI Global Ex-U.S. USD Hedged Index; JP Morgan EMBI Global Index (measures external debt); Credit Suisse Institutional Leveraged Loan Index. The high yield, EM and senior floating rate indexes did not exist during periods marked n/a. Non-U.S. developed data is through the nearest month end.

Source: PIMCO

Note that ***many areas of the bond market had positive returns during these periods of "rising interest rates"***. This shows that, as mentioned, returns from bonds are affected by more than just what the Fed is doing. Another observation is that even in the 1994 episode, which those of us with more experience can still vividly recall, the negative bond returns for all but the riskiest areas were difficult but hardly catastrophic. This proves the adage that ***"a bad year in the bond market is like a bad week in the stock market"***.

Today the Fed is in another period of "rising interest rates" that began in December 2015. But after 13 months (longer than three of the four periods in the chart above that covers the last quarter century) the increase in the Fed Funds Rate is a mere 50 basis points (or 0.50%). Our position for several years has been that the now current period of tightening will take place slowly and gradually because ***growth is likely to remain sluggish and inflation is likely to remain low***, even if both are slightly higher than the past few years. That is, the country is not likely to experience a dramatically higher interest rate regime over the next few years.

> We might hazard a guess that there could be one or two similar hikes in 2017, depending on how both the global and domestic economies evolve. Note that this is not a prediction, as no one can know for certain because even the Fed does not know what they will do as evidenced by their constantly changing dot plots they publish a few times a year and their rather poor track record of past forecasts.

As the past demonstrates, though not necessarily indicative of future results, bonds can still have decent if modest returns in such a scenario. In large part this is because ***when bonds mature in a portfolio, the proceeds can be used to purchase bonds that have higher yields***. Down the road, the higher yields will mean higher nominal returns for bonds. Real returns, or purchasing power, need not be sacrificed if inflation remains low, as we expect and as the Fed has a congressional mandate to maintain. This is why bonds can remain a part of a diversified portfolio as appropriate for one's circumstances, even with "rising interest rates".

For what it's worth, since the Fed made their first rate increase on December 16, 2015 through January 27, 2017, the Bloomberg Barclays US Aggregate Bond Index (a broad-based flagship benchmark) has had a *positive* cumulative total return of about 2.6% (per Morningstar). So much for "rising interest rates" being a broad problem for bonds, at least so far.

Enjoy the ride!

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