Bonds and Interest Rates

A look at how one can greatly affect the other.

Provided by IWM Partners

Is the bond bull history? Bond titan Bill Gross called an end to the 30-year bull market in fixed income back in 2010, and he has repeated his opinion since. Legendary investor Jim Rogers predicted an end to the bond bull in 2009, and he still sees it happening. This belief is starting to become popular – the Federal Reserve keeps easing and more and more investors are leaving Treasuries for equities.[1,2,3]

If the long bull market in bonds has ended, the final phase was certainly impressive. During the four-year stretch after the collapse of Lehman Brothers, $900 billion flowed into bond funds and $410 billion left equities.[2]

In 2013, you have bulls running, an assumption that Fed money printing will start to subside and the real yield on the 10-year TIPS in negative territory. Assuming the economy continues to improve and appetite for risk stays strong, what will happen to bond investors if inflation and interest rates rise and bond market values fall?

Conditions hint at an oncoming bear market. If interest rates rise again, how many bond owners are going to hang on to their 10-year or 30-year Treasuries until maturity? Who will want a 1.5% or 2.5% return for a decade? Looking at composite bond rates over at Yahoo's Bonds Center, even longer-term corporate bonds offered but a 3.5%-4.3% return in late March.[4]

What do you end up with when you sell a bond before its maturity? The market value. If the federal funds rate rises 3%, a longer-term Treasury might lose as much as a third of its market value as a consequence. It wasn't that long ago – June 12, 2007, to be exact – when the yield on the 10-year note settled up at 5.26%.[5]

This risk aside, what if you want or need to stay in bonds? Some bond market analysts believe now might be a time to exploit short-term bonds with laddered maturity dates. What's the trade-off in that move? Well, you are accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities if rates rise. If you are after higher rates of return from short-duration bonds, you may have to look to bonds that are investment-grade but without AAA or AA ratings.

If you see interest rates rising sooner rather than later, exploiting short maturities could position you to get your principal back in the short term. That could give you cash which you could reinvest in response to climbing interest rates. If you think bond owners are in for some pain in the coming years, you could limit yourself to small positions in bonds.

The Treasury needs revenue and senses the plight of certain bond owners, and in response, it has plans to roll out floating-rate notes by 2014. A floater backed by the full faith and credit of the U.S. government would have real appeal – its yield could be adjusted per movements in a base interest rate (yet to be selected by the Treasury), and you could hold onto it for a while instead of getting in and out of various short-term debt instruments and incurring the related transaction costs.[6]

Appetite for risk may displace anxiety faster than we think. In this bull market, why would people put their money into an investment offering a 1.5% return for 10 years? Portfolio diversification aside, a major reason is fear – the fear of volatility and a global downturn. That fear prompts many investors to play “not to lose” - but should interest rates rise significantly in the next few years, owners of long-term bonds might find themselves losing out in terms of their portfolio’s potential.

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***Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.**

****Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.**

*****Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.**

******Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index – while providing a real rate of return guaranteed by the U.S. Government. TIPS are subject to market risk and significant interest rate risk as their longer duration makes them more sensitive to price declines associated with higher interest rates.**

*******Floating rate notes are often lower-quality debt securities and generally are subject to restrictions on resale. They involve greater risk of price changes and defaults on interest and principal payments. They may not be fully collateralized which may cause the floating rate loan to decline significantly in value.**

Citations.

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2 - online.wsj.com/article/SB10000872396390443884104577645470279806022.html [9/15/12]
3 - www.bloomberg.com/news/2013-02-07/u-s-30-year-bond-losses-pass-5-as-fed-price-gauge-rises.html [2/7/13]
4 - finance.yahoo.com/bonds/composite_bond_rates [3/27/13]
5 - www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2007 [2/6/13]
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