THE BRIGHT SIDE OF HIGHER RATES

JULY | 2013

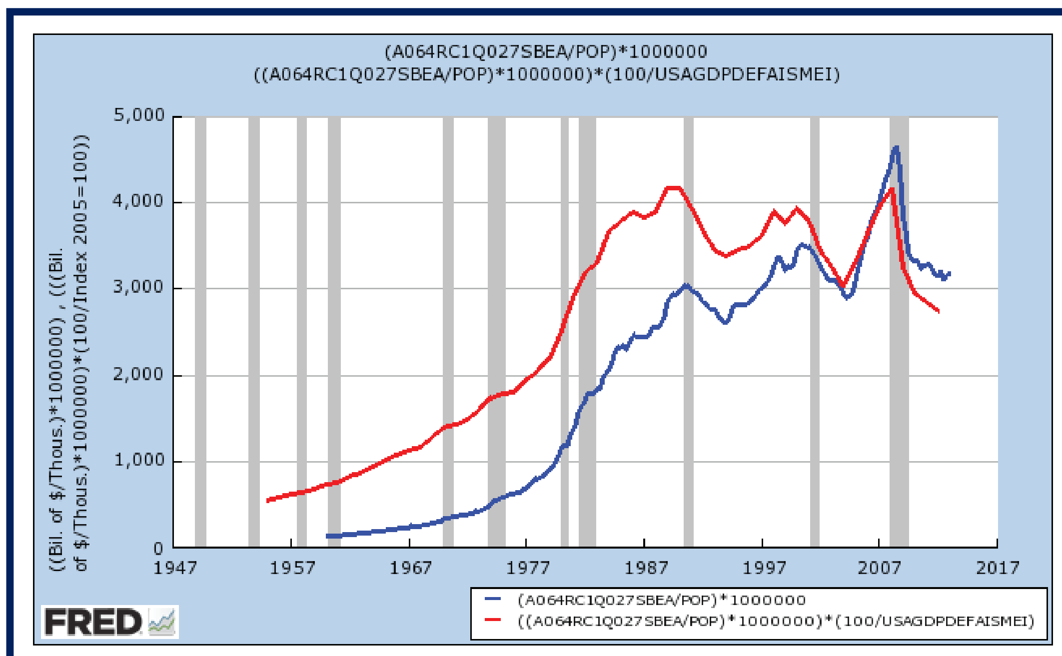
Interest rates spiked higher in the second quarter. The benchmark 10-year US Treasury note yield, which was at 1.63% at the beginning of May, moved as high as 2.63% before finishing June at 2.49%. Bond prices, which move inversely to yields, fell sharply, and as a result bonds had their worst quarterly return since 2010. The aggregate bond index is down 3% in 2013 through the end of June. The bond selloff has been broad; treasuries, corporates, municipals, and global bonds were all affected.

The proximate cause for the rise in rates were statements by Ben Bernanke and other Federal Reserve Governors hinting that they were looking at ways to “taper” their quantitative easing programs. “Quantitative easing” by the Federal Reserve was first initiated in 2010 in order to bring down longer-term rates, notably mortgage rates. The most recent quantitative easing program, “QE3”, started last September and involved open-market purchases of US Treasury and Agency Mortgages. The Fed’s quantitative easing programs have been effective at suppressing longer-term interest rates, as evidenced by the low mortgage rates that have helped to rekindle the housing markets.

Interestingly, the low interest rates have yet to spark a meaningful rise in inflation. Historically, extended periods of low interest rates have fostered rising inflation, and most investors (ourselves included) have feared that we would start to see a rise in the consumer price index and commodities. To the contrary, most commodity prices have fallen sharply in 2013, with gold down 28% year to date!

A main reason why inflation has remained so low is that per capita income has been falling. Wages have been static, but just as damaging is that personal interest income per capita has declined significantly – in large measure because of the low interest rate policies of the Fed! Quantitative easing has helped banks and borrowers, but it has hurt savers and investors. The chart below, courtesy of the St. Louis Federal Reserve, shows that since 2008, the average American has lost over $1,000 in interest income per year – retirees and savers have suffered the worst.

Personal Interest Income per Capita (blue line) and Inflation Adjusted Personal Income per Capita (red line)



The Federal Reserve's low interest rate policies are significantly depressing disposable incomes, thereby depressing consumption. The net result is slower economic growth. The Fed's policies have helped to repair banks, assisted in the housing market's recovery, and allowed consumers and corporations to deleverage through lower borrowing costs. By now, there is not a lot of marginal benefit to keeping rates low, but there is certainly a high cost for savers and investors. This seems to be the Fed's new viewpoint.

Not surprisingly, the media's coverage of the rise in interest rates has been alarmist. Fear is an easy sell and scary headlines get much more attention. Investors reacted by pulling more than $24 billion out of bond mutual funds and ETFs in June, the largest monthly withdrawal since October 2008. The market value of existing bonds has fallen, and this is an especially unnerving experience for people because fixed-income investments are considered "conservative". However, the long-term benefits of higher rates for investors outweigh the short-term discomfort caused by rising rates.

The core reason to own a fixed income investment is to generate income. When you buy a bond, you're effectively lending money in exchange for regular interest payments from the borrower. Fixed income investors are not principally focused on the unrealized capital gains that can come from falling rates, nor should they be overly concerned by unrealized capital losses that can come from rising interest rates. Prices will rise and fall, but the real value is in securing the higher interest payments. The lower the prices, the better the opportunity to secure a bigger income stream from an investment. Over time, this will lead to greater wealth creation.

In some cases, high quality corporate bond yields have moved from 2% to 4%, mathematically the same as a 50% sale at the supermarket. If this were a 50% off sale at the local supermarket, shoppers would be flooding the stores. Perhaps some shoppers would wait for an even bigger sale, but many would stock up on household "staples" at good low prices.

Here are strategies that one should employ when managing fixed income portfolio:

Diversification

Own a number of bonds across a variety of industries and issuers, limiting single issuer exposure. A good allocation will take into account risks of the issuer, but also the industry, sector and asset class.

Duration

Stagger when fixed income investments come due, thus providing ongoing reinvestment opportunities. Owning shorter-term bonds may pay a less than longer-dated bonds, but they offer the investor another chance to reinvest the money into future higher interest rates at maturity.

Quality

Concentrate on investments that a high degree of confidence will make their interest payments and return the principal at maturity. A bond is a debt of the issuer. Debts are leverage, and as such increase risk. An investor seeking income wants and expects to be repaid their principal. A strong balance sheet with plenty of free cash flow is important. Corporations and municipalities and other debt issuers should be experiencing a period of improvement in their balance sheet strength. If they are not, move on.

Typically, the interest rate on an income investment is tied to the risk of the issuer. Higher rates can signal higher risk. The best opportunities exist when an issuer is improving its cash flow and balance sheet strength.

While is does seem likely that rates are going to continue to move higher, it is far from being a certainty. It is unusual for interest rates to rise so sharply without a corresponding rise in inflation. Looking at the past 50 years, in virtually every period when interest rates have risen, inflation expectations were increasing and credit risk problems were in decline.

Interest rates can't keep rising without higher inflation or better economic growth. Credit spreads can't keep rising if the risk of default is falling, i.e., the economy is growing. We have a bit of a "something's gotta give" moment occurring. Either inflation will start to pick up, GDP will grow faster, or interest rates will come back down.

If the US economy continues to grow and accelerates, the equity and real estate portions of investor's balance sheets will be improved. If higher rates cause an economic slowdown, and the US economy contracts, the Federal Reserve is very likely to announce a new easing program that will send rates lower.

Rising rates have caused prices of income-oriented investments to fall in the short run, but the long-term prospects for the conservative portion of investor balance sheets has improved dramatically. Many high quality corporate and municipal bonds have sold off and are now offering significantly higher cash flows to investors.

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