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Selling Your Bonds as the Fed Raises Rates?

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In this article we review four commonly held misconceptions regarding the Fed's plan to raise rates and the implications for bond investors:

Misconception #1: If the Fed is raising rates, the economy must be in pretty good shape.

Misconception #2: If the Fed raises rates, longer-term bonds will likely underperform.

Misconception #3: If the Fed raises rates, short-term bond returns will turn negative; therefore, I should sell my short-term bonds.

Misconception #4: Futures and forward markets tell us when the Fed will raise rates.

Background

It seems like we've been hearing the following from financial market pundits for the past several years: "Since interest rates are bound to go up, why should I hold bonds in my portfolio?" And now that the Fed appears to be on the verge of raising short-term interest rates, this concern is likely to intensify. Embedded in this concern are a variety of incorrect assumptions and outright misconceptions.

In this article, we seek to shed light on certain key relationships between Fed interest rate policy, the economy, short- and long-term bond yields, bond performance, and market expectations.

In the end, we believe that bonds should represent an important asset class in any portfolio. In fact, we believe investors shouldn't reduce their fixed income allocations simply because the Fed embarks upon a campaign to raise interest rates.

Misconception #1

If the Fed is raising rates, the economy must be in pretty good shape.

Reality: The Fed will likely raise rates even if the economy is still very weak in certain key areas.

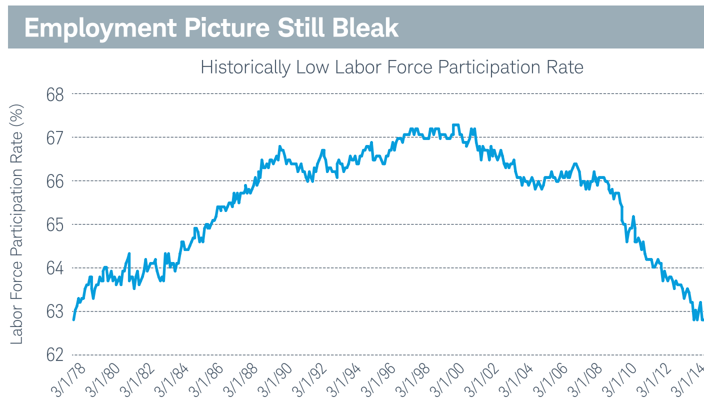
Typically, when the Fed embarks on a rising-rate campaign, it's due to a fundamentally healthy picture for the economy. Specifically, the Fed's decision to raise interest rates is often in response to a quickly growing labor market and concerns that the job market is starting to overheat, which can drive up inflation.

The current environment is quite unique. Though the job picture has somewhat improved, it's a far cry from the progress we have seen during typical post-recession recoveries.

As all of these charts underscore, the overall U.S. economy is still in poor shape. Even though we're better off now than just a few years ago, the employment picture in particular remains pretty bleak. But rates have been abnormally low for many years now. This is worrisome to the Fed because the longer rates stay historically low, the bigger the chance that destabilizing asset bubbles, runaway inflation, or other dangerous economic circumstances may arise. So even though the U.S. economy remains somewhat troubled, the Fed needs to start normalizing interest rate relationships to help keep the economy in balance.

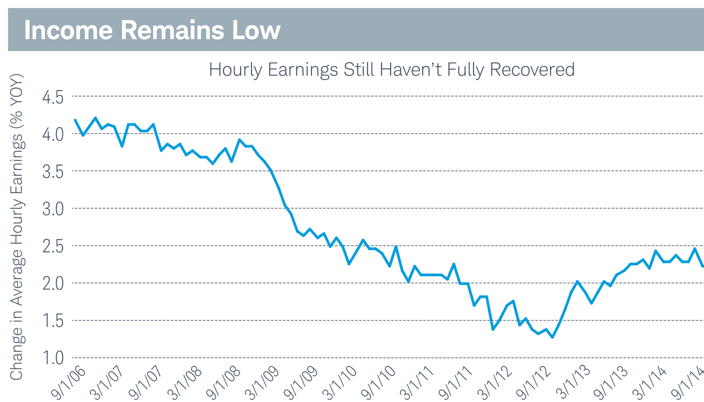
CHECK THIS OUT:

Fewer people are working: As shown in the chart below, the portion of the labor force actually employed hasn't been this low since 1978 and continues to fall!



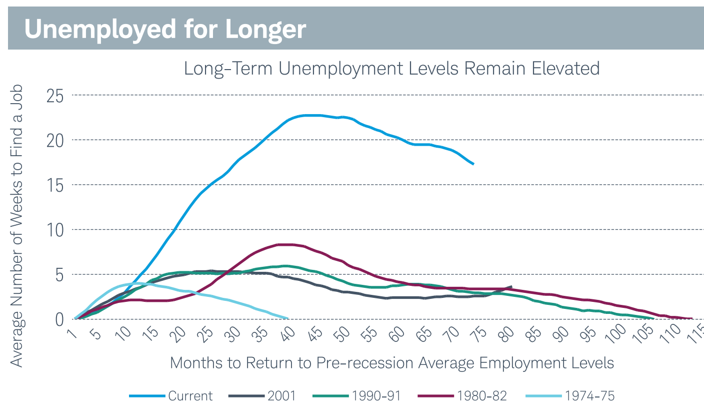
Source: Bureau of Labor Statistics

Income growth remains low: Average hourly earnings are not increasing at the same rate as they were before the financial crisis.



Source: Bureau of Labor Statistics

People have been unemployed longer: The number of people unemployed for an extended period of time is substantially higher than at any time prior to the financial crisis.



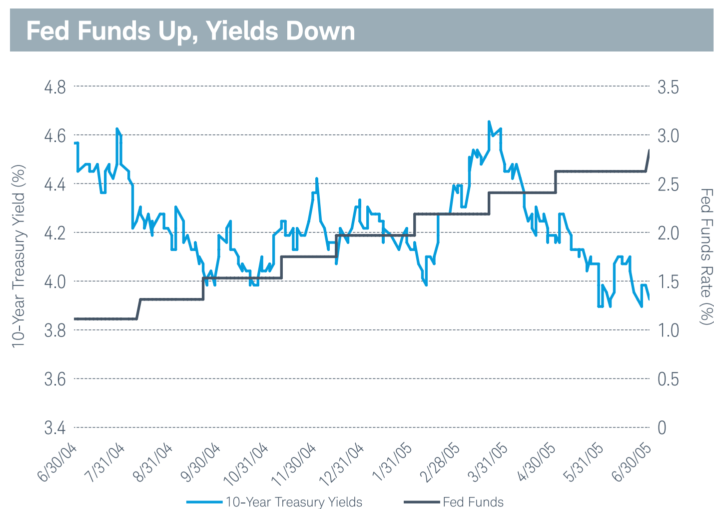
Source: Bureau of Labor Statistics

Misconception #2

If the Fed raises rates, longer-term bonds will likely underperform.

However, as the chart below shows, the yield on the 10-year Treasury actually fell from mid-2004 to mid-2005, even as the Fed was raising rates.

Fed Funds Up, Yields Down



Sources: Bloomberg; Federal Reserve Bank of St. Louis, Federal Reserve Economic Data

Reality: Longer-term bonds can outperform even when short-term interest rates rise.

It's important to appreciate that there is a significant difference between short-term rates and long-term rates. The Fed is able to directly influence short-term rates, but its ability to affect long-term rates is quite nebulous.

In fact, it's not at all unusual for long-term rates to fall (and bond prices to rise) during periods in which the Fed is actively raising short-term rates. Long-term rates are primarily driven by inflation and growth expectations, along with technical factors that are influenced by supply and demand.

Consider the scenario back in 2004, the last time that the Fed embarked on a campaign to raise interest rates. Much like today, investors worried that these actions by the Fed would drive up long-term interest rates as well. This concern was certainly understandable given the economy's rapid growth, and that inflation was viewed as a potential problem. Against this backdrop, the Fed raised short-term interest rates. This scenario is illustrative because the Fed didn't raise short-term rates just once or twice, but rather many times, increasing them from 1.00% to 5.25%.

Therefore, instead of generating losses, bonds turned in resilient returns even while the Fed embarked on its rising-rate campaign, as the table below illustrates.

Calendar Years	Barclays U.S. Aggregate Bond Index Return
2004	4.34%
2005	2.43%
2006	4.33%
2007	6.97%

Source: Barclays Live

Given that long-term bond yields may not rise during a Fed rising-rate scenario, and can actually fall (causing bond prices to rise), we believe it's important for investors to maintain a long-term, well-diversified approach to holding bonds in their portfolios.

Misconception #3

If the Fed raises rates, short-term bond returns will turn negative; therefore, I should sell my short-term bonds.

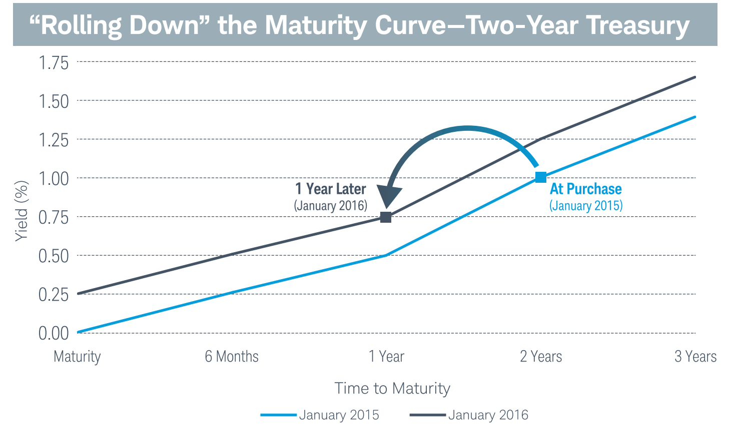
Reality: Short-term bond returns can be positive even while short-term rates rise.

While bond prices and yields tend to move in opposite directions, narrowly focusing on this relationship can lead to wrong thinking about potential bond returns. The performance of short-term bonds is affected by the yield curve, the impact of rolling down the yield curve, and by a bond's term to maturity.

The yield curve often isn't flat. In fact, it's frequently upward sloping, as is the case currently. Since a bond ages as it approaches maturity, the bond continually trades like a shorter and shorter term security, and therefore the bond's yield can fall over time even as rates are rising.

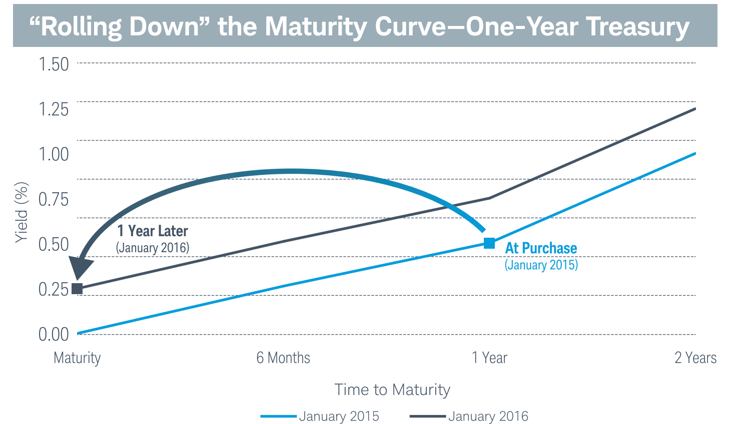
Consider the following scenario: two-year Treasury securities yield 1.00% in January 2015, and one-year Treasury securities yield 0.50%. Imagine if all interest rates rise by 25 basis points (0.25%) over the next year.

Here's what this would look like for the two-year Treasury:



This chart is a hypothetical example for case study only. Does not reflect actual market activity.

In this scenario, the two-year Treasury eventually becomes a one-year Treasury, and its yield falls from 1.00% to 0.75% as it rolls down the maturity curve from January 2015 to January 2016. The security provides 1.00% in coupon income over the course of the year and 0.25% in price return. In spite of the rise in interest rates, the security generates a total return of 1.25%.Under the same scenario, here's what this would look like for the one-year Treasury:



This chart is a hypothetical example for case study only. Does not reflect actual market activity.

As the one-year Treasury rolls down the maturity curve from January 2015 to mature on January 2016, it provided 0.50% in coupon income over the course of the year, and a 0.25% price return. In spite of the overall rise in interest rates, the security generates a total return of 0.75%.

The counterintuitive points are: (1) Short-term bonds have the potential to generate positive returns, even when rates are rising; and (2) longer-term securities can outperform shorter-term securities, even as rates are rising.

Misconception #4

Futures and forward markets tell us when the Fed will raise rates.

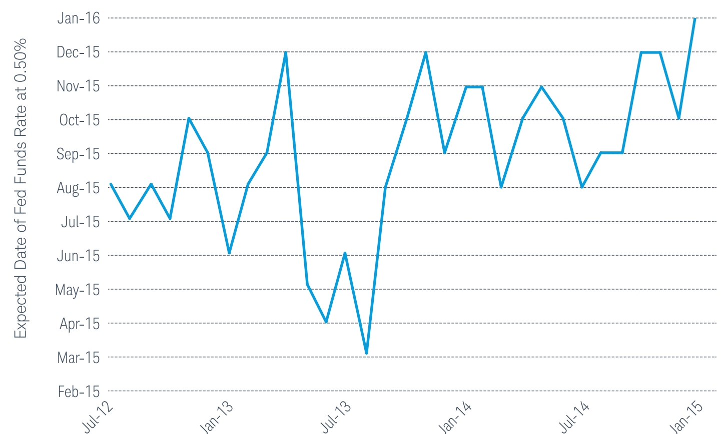
Reality: Futures and forward markets are often WRONG!

Financial market pundits, economists, and portfolio managers are constantly analyzing interest rate futures and forward markets to assess the projected timeline associated with the Fed's interest rate policies. The problem is that these futures and forward markets are often poor indicators of what actually comes to pass.

CONSIDER THE FOLLOWING:

A moving target: Expectations about Fed policies are constantly in flux!

Changing Expectations for Short-Term Interest Rates



Source: Bloomberg; forecast data as of 1/23/15

The inescapable conclusion from the chart above is that interest rate expectations are always in flux. And the very fact that they're constantly changing speaks to the futility of trying to use futures and forwards to try to make interest rate predictions. So instead of trying to time the financial markets, we think an investor is far better off focusing on the value that fixed income securities can provide.

Wrapping It Up

There's a great deal of conventional "wisdom" relating to the potential impact of a change in Fed policy on bond returns. We think that most of it is just hype. It's wrong to think that all interest rates will rise together and that bond returns will turn negative simply because the Fed raises rates. It's important that investors understand the fundamental relationships between Fed interest rate policy, the economy, short and long term bond yields, and bond performance. It's not at all clear that long term bond yields will rise as the Fed raises rates. Consequently, investors may regret selling bonds on the premise that all rates rise and fall together. We believe that investors should focus on the long term, and maintain an appropriate allocation to fixed income securities regardless of the Fed's rate policy.

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