Fund Managers Ltd.

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Insight!

Rising Interest Rates Expectations - Are Bonds Worth Buying?

After allowing interest rates to remain at historically low levels in most major markets around the world, to aid their economies combat the economic and social effects of COVID-19, it now appears that a shift to a scenario of tighter monetary policy, even if only temporarily, to stifle what many thought and likely still believe will be transitory inflation, is imminent. Inflation is predicted to decline over the course of the next year owing to slow growth, relatively high unemployment and presumably fewer supply-side issues. However, central banks must avoid inducing an inflationary mindset, in which high inflation expectations are firmly embedded, resulting in higher output prices and workers demanding wage increases. What a quandary!

The International Monetary Fund (IMF) appears to recognize the dilemma policymakers face in trying to balance the need to facilitate growth in a generally weak economic environment while also preventing high inflation expectations from derailing the long-term growth potential of the various economies in its most recent World Economic Outlook. Some policymakers have hinted at the possibility of quantitative tightening, which, in theory, would have the same effect as increasing rates. Others, it appears, might not have had the luxury of time or the flexibility and have already started its tightening. Jamaica's central bank is one such example.

Why should investors buy bonds if we believe that interest rates are more likely to increase from their current low levels? This is a very relevant and serious topic posed by a number of clients and various stakeholders given the fact that bonds usually perform poorly in a rising interest rate environment. There are a number of reasons for this, but we won't go into detail about them here. Instead, we want to discuss why bonds should continue to be relevant to clients and play a significant role in any scenario, even when rates are rising. Let's talk about it.

Diversification

Bonds and equities have historically had fairly low correlations. But what does this actually imply? In a nutshell, bond prices rise when stock prices decline. This effect is one of the most compelling reasons to invest in bonds. Because what affects the stock market does not always affect the bond market or at least not in the same magnitude and vice versa. Therefore, buying bonds provide some level of diversification benefits. As a result, including bonds in a portfolio of stocks has the ability to function as a ballast, potentially smoothing out a return during periods of volatility. Furthermore, because the COVID-19 pandemic is still evolving, there is no guarantee that the economic recovery would continue unabated across all economies. In fact, we expect a few hiccups along the road, as low vaccination rates around the world mean many economies remain vulnerable.

Capital Preservation

Another benefit of investing in fixed income instruments is their ability to preserve capital. If the value of equities declined dramatically, a portfolio that consists of only equities could lose a substantial amount of capital. This is a frightening prospect for investors with nearing financial obligations or retirement, and it emphasizes the importance of bonds in capital preservation. This is especially enticing to investors with low-risk tolerance. While investors can lose part or all of their principal invested in bonds, the likelihood of this occurring is far lower for bonds than in equities. Furthermore, investment-grade bonds have a strong track record of providing positive total returns, making them desirable to these investors and those intending to fund future obligations.

Bonds issued or guaranteed by stable governments such as the United States of America (US) or the United Kingdom (UK), as well as firms with sound business models and healthy balance sheets can be key building blocks of a capital preservation strategy. Bonds structured with strong collateral can achieve very high-quality ratings at the upper end of the investment-grade spectrum.

While past performance is no guarantee of future results, the U.S. Aggregate Bond Index has not led to any losses over any three-year period within the last 20 years. In comparison, the S&P 500 has been positive 78% of the time, over the same period.

Steady Income

A fixed-income security's ability to provide fixed, steady cash flows is another fundamental benefit. After all, there is a reason it is called fixed income. Although some equities pay dividends, the amount of the pay-out and the timing of those cash flows are never guaranteed. Bonds, on the other hand, offer more predictable income streams in the form of coupon payments, assuming the bond issuer remains solvent. These steady streams of income are valuable to an investor who has obligations on a monthly, quarterly, or semi-annual basis etcetera.

Predictable Cash Flows, Investable at Higher Reinvestment Rates

Most bonds promise to pay a periodic coupon to investors. Investors who receive bond coupons in an environment where interest rates are increasing may have an opportunity to invest those cash flows in an instrument with a higher coupon or reinvestment rate. The reinvestment rate, as the name suggests, is the rate at which cash flows from one investment can be invested in another.

As investors try to navigate what is anticipated to be a very volatile period, it is now more important than ever to maintain a diversified portfolio. We anticipate that as economies continue to reopen and supply and demand mismatches that are currently holding back economic activity globally are resolved, robust economic growth will lead to positive spinoff benefits for company profits and equities in general, making equities appear relatively attractive when compared to bonds. However, history and the characteristics of bonds have shown that fixed income securities may still play an important role in a portfolio, even in an increasing interest rate environment.