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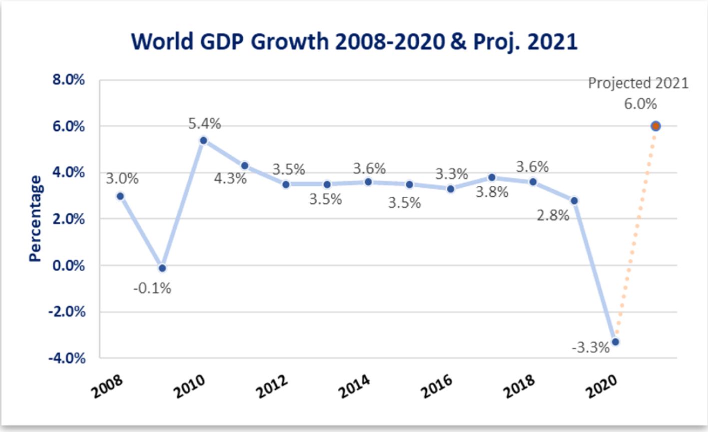
Insight!

Rising Yields and the Bond Market (Part 2)

In our previous article, we discussed the steep rise in yield that has been observed since the start of 2021. We also looked at the current breakeven rate, and by extension, investors' inflation expectations, as they bet on a general economic recovery in the aftermath of the COVID-19 pandemic. It is not unreasonable to expect further increases in inflation and bond yields if economies continue to reopen and the general decline in unemployment continues, even as the global vaccination programmes are being rolled out. We must agree that we cannot predict the future, but we must also acknowledge that planning makes life much easier. Consequently, in this second article, we will look at what investors can do if (and that's a big 'if') rates continue to increase, and how they can position their portfolios in light of their expectations. Prices are determined by the laws of supply and demand through various variables, such as interest rates, inflation rates, exchange rates, and so on, which inherently influence broader economic activities. This is particularly important given that almost every economy in the world is currently market-based. Since yields are calculated with these variables in mind, they are an even more reliable or one-stop-shop predictor of economic activity.



According to the IMF, the global economy contracted by 3.3 per cent in 2020 following the 10-year stretch of positive growth, which averaged 3.4 per cent annually. Now, it could be argued that the global economy is currently in an early-stage expansion phase. During an expansion phase, the economy typically experiences relatively strong growth, interest rates are usually lower, demand increases and inflationary pressure builds - which is what we are observing now, to some extent. An increasing interest rate scenario is usually better for stocks than bonds, or at least for certain stocks. Rising yields are a 'mixed bag' for stocks in the technology and other high growth sectors, as investors are concerned that higher rates would erode the long-term cash flows expected from owning these companies. Financial sector stocks, on the other hand, are expected to perform relatively well. Borrowers have an easier time making loan payments as the economy improves, and banks, for example, may benefit more from the difference between what they pay and what they earn.

Bond prices move in the opposite direction of interest rates, and improved risk appetite generally encourages investors to purchase riskier assets than bonds, lowering the demand for bonds and ultimately its price. If you are a bond investor, you may be thinking about selling your bonds by now, or at least you may be thinking about it. While selling bonds with the expectation that interest rates will increase can seem prudent, a 'knee-jerk' decision can be catastrophic. Instead, if you have an investment policy statement (IPS), now would be a good time to review it, and if you don't, now is a good time to create one. If you can't recall the reason you bought bonds in the first place, a review of your IPS should help. If you depend on bonds for diversification rather than anything else as an investor, it is recommended that you stick to them. One of the most important benefits of investing in bonds is that it helps to balance the risk in a portfolio context. You see, while it is widely assumed that interest rates will continue to rise, this is far from certain.

Special Insights...

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Some investors depend on bonds for their cash flow characteristics. In a rising interest rate environment, the fixed cash flow nature of fixed-rate bonds is unattractive from two perspectives. One: the future cash flows from these investments will be discounted at a higher rate, resulting in lower flows; and two: the purchasing power of fixed periodic cash flows dwindles due to the likely higher inflation. In this scenario, higher-yielding bonds may be preferred as these bonds tend to have higher coupons, provide better compensation to investors for the decline in value, and are generally less sensitive to rate increases.

Inflation-protected bonds, which are specifically designed to guard against rising inflation, are an effective solution for those bond investors who depend on bond income, but are worried about inflation increasing rapidly. Treasury Inflation-Protected Securities (TIPS) are among the most attractive within this class. TIPS' face value is linked to the Consumer Price Index (CPI) and is adjusted in line with changes in inflation, and interest is paid on the adjusted face value, creating a rising stream of income, as long as inflation continues to increase. At maturity, TIPS investors receive the original face value of the bond plus the sum of inflation adjustments made since the bond was issued.

Another strategy that investors may pursue is to invest in shorter-term duration bonds. By doing this the investor reduces their exposure to changing interest rates by shortening the time between when you buy a bond and when it matures. Short-term bonds will help protect you from the negative impacts of rising inflation expectations.

In an improving economy, inflation protection tends to lead investors to add more equities at the expense of fixed income. In theory, equities offer more upside potential and have historically demonstrated the ability to generate returns that exceed inflation. Investing in equities can lead to greater volatility, making it more difficult for an investor to achieve their investment objectives. However, bonds can still play an important role within a diversified portfolio, even in a rising interest rate environment. Bonds, when used appropriately, can help create a smoother investment experience; however, the aim is to carefully choose the investments with deliberate strategies to match the investors' risk appetite, while hedging against increasing interest rates.

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