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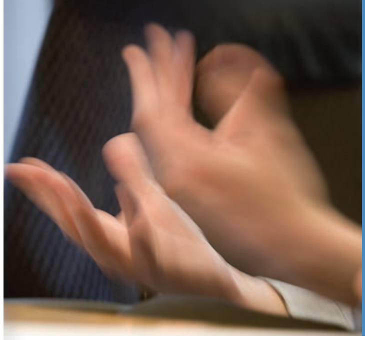

Viewpoint

December 2015

Rising Rates: Dispelling the Myth

Fear can get in the way of sound judgment. U.S. President Franklin Delano Roosevelt recognized this in his famous 1933 inaugural speech, when he advised Americans not to be paralyzed by “nameless, unreasoning, unjustified terror.” With wealth and jobs evaporating at an alarming rate in the depths of the Great Depression, it must be said that some fears were quite justified. FDR was right, however, to highlight the importance of not making a difficult situation worse by panicking.

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Today’s bond investors could take note: With bond yields low and the Federal Reserve embarking on an interest rate hiking cycle, there are plenty of real concerns facing investors. But a reasoned analysis that takes into account historical interest rates, the likely path of rates going forward and the impact of past interest rate rises on returns suggests that rising rates may not be such a threat to bond investors.

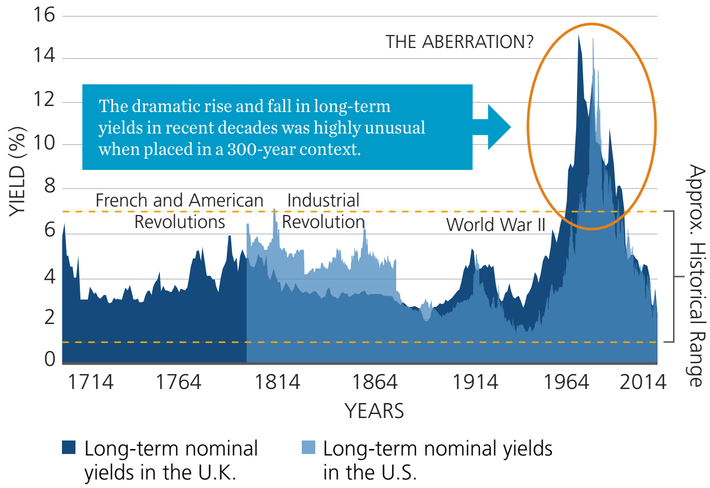
The arguments for holding core bonds as part of a well-diversified portfolio are as strong as ever, and those who overreact to the prospect of rising interest rates may be doing themselves – and their investment portfolios – a disservice.

What goes down must come back up?

With interest rates near rock bottom, some investors believe that a bear market in bonds is inevitable. They may be focused on the notion of symmetry – the idea that there must be an equal and offsetting rise in yields as the natural counterpart to the drop in yields in recent decades.

Yet the bears miss an important point: The three-decade drop in yields was itself the counterpart to the bond bear market of the 1960s and 1970s, when yields rose to historically unheard-of levels as the Fed attempted to rein in sky-high inflation (see Figure 1).

FIGURE 1: BOND YIELDS: BACK TO THE FUTURE



Source: Bank of England, U.S. Treasury, Global Financial Data, PIMCO as of 31 December 2014

Rather than selling bonds in preparation for the return of such an abnormal environment, investors should focus on what is more probable in the current environment of modest growth and low inflation: a rise in yields, but one that is likely to be gradual and ultimately limited in scope.

Afraid of the big bad Fed

Bond prices typically fall as interest rates rise. So with the Fed raising interest rates, are bonds the right place for investors to be? Three points are worth bearing in mind.

First, the Fed is unlikely to raise rates as fast or as far as it has in previous cycles. In fact, we think the equilibrium level of the fed funds rate – the level at which the Fed is neither tightening nor easing – is between 2.0% and 2.5%. This is at least two percentage points lower than the neutral rate in the past few cycles.

Second, it's important to remember that markets are forward-looking. Since investors expect that the Fed will continue to raise rates, prevailing yields on longer maturity bonds are significantly higher than the range the Federal Open Market Committee (FOMC) has established for the fed funds rate. Put another way, the markets are "pricing in" future rate hikes. This means that for bonds to underperform a cash investment, rates do not simply need to rise – they need to rise faster than the market expects.

Lastly, a look at the history of rate-hike cycles is instructive for those concerned about investing in bonds at this point in the interest rate cycle. In particular, we would look to the experience of 1994, when the Fed delivered a series of rate hikes that took the overnight rate from 3% to 6%. While bond yields also rose quite a lot in response to the FOMC's moves, the Barclays Aggregate Bond Index (at the time called the Lehman Aggregate but that's another story…) declined less than 3% over the course of 1994. A 3% loss is hardly catastrophic, and today, even that seems highly unlikely given that we expect a much less aggressive Fed than in 1994.

The upshot: bond investors should pay attention to the Fed, but they should not live in fear of its huffing and puffing.

Be careful what you wish for

There's another critical point to keep in mind: Contrary to popular belief, bond investors may actually be better off if rates rise than if they fall. On its surface, that statement seems counterintuitive; bond prices move in the opposite direction of yields, so a fall in interest rates leads to an increase in prices while rising rates cause prices to fall. So why would a bondholder prefer rising rates?

The answer lies in the mechanics of bonds. Default risk aside, the cash flows for a fixed rate bond are known in advance. So while the price of the bond may change as yields move up and down, the total return of a bond held to maturity will not. A rise in prices simply "brings forward" some of the bond's future return while a fall in prices pushes some of that return into the future; neither affects the total return investors earn over the bond's life.

However, when it's time to reinvest bond proceeds from coupon payments or maturities, changes in interest rates do matter. If interest rates fall, an investor must accept the lower yields that are available in the market at the time of reinvestment. Should rates rise, however, an investor can reinvest at higher yields. As long as an investor has a multi-year investment horizon, this reinvestment effect means that the investor should ultimately be better off if rates rise than if they fall.

Not convinced? Then let's take another look at the 1994 rate-hike experience. At the end of 1993, the yield on the Barclays Aggregate was approximately 5.8%. Over the course of 1994, that yield rose to over 8%, which was the main driver of the ~3% loss in return the index experienced for the year. During 1995, by contrast, yields came back down, with the result that the yield on the index ended the year at just above 6%. Had yields remained steady over the entire two-year period, an investor might have expected a total return similar to the starting yield of the index. Compounded over two years, a 5.8% yield would generate a total return just shy of 12%.

So how much did the index actually return over that period? Even though its yield rose slightly from the end of 1993 to the end of 1995, the index returned a cumulative 15%, or approximately 3% more than expected based on the starting yield. For many bond investors, the rise in yields during 1994 was far from a bad thing.

The difficulty with prediction

At this point, an astute observer might point out that an investor would have done even better by selling bonds at the end of 1993 and buying them back a year later. Indeed, given perfect foresight, it would make the most sense to sell bonds just before yields begin to rise and then buy them back when they reach their cheapest point. The rub is that, as Yogi Berra so famously pointed out, "prediction is difficult, especially about the future."

In the real world, perfect foresight tends to be much harder to come by than 20-20 hindsight. Looking at stocks, for example, many investors have imagined buying at each cycle's trough and selling at each peak. But such is the stuff dreams are made of.

When even Fed Chair Janet Yellen doesn't know with certainty where or when FOMC rate hikes will stop, it is a serious challenge for an investor to time the bond market. And, since moving out of bonds is an explicit de-optimization of an overall portfolio, timing matters a lot. Fleeing to cash yielding near 0% may result in something akin to "death by a thousand cuts" if yields don't rise as soon as expected. And moving from bonds to stocks may be cause for regret if stock markets hit a speed bump: Capital gains from bonds have tended to kick in just when equities have sold off, helping to stabilize overall portfolio performance.

So while it may seem intuitive to reduce core bond holdings in anticipation of yield normalization, investors shouldn't underestimate just how difficult it is to time the market.

Fear only 'fear itself'

Investors today have plenty of legitimate concerns. Yields and prospective returns are generally low across asset classes. And the global financial landscape can be daunting, with news from China just as likely as a Fed statement to roil markets. Yet when it comes to rising interest rates, long-term bond investors may have little to fear and even, potentially, something to gain.

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