Brightworth

Published on *Brightworth* (https://www.brightworth.com)

Home > Will rising interest rates sink my bond investments? (Part 1)

Will rising interest rates sink my bond investments? (Part 1)

Jeffrey A. Harrell, CFA [1] | Director of Portfolio Management

Interest rates have been on the rise lately causing many investors to become increasingly nervous that the upward trend may have much further to go. Countless media sources are fanning these fears as they routinely produce content highlighting a host of possible catalysts to support even higher interest rates. This narrative typically ends with how devastating rising interest rates will be to your bond investments, often suggesting these investments are riskier than your stock holdings.

Where to start with these wild accusations?

First, it is important to recognize that the Federal Reserve has pledged to keep short-term interest rates at essentially 0% for an extended period of time, most likely measured in years. Further, when you compare U.S. interest rates to the rest of the developed world you may ask yourself a very interesting question. Why are their rates so much ***lower*** than ours? Look no further than Europe. As you can see from the table below, most European countries can borrow money at a lower interest rate (in many cases negative) than the United States…even Greece!!

Country	Credit Rating	10 Year Government Bond Yield
United States	AA+	1.75%
Germany	AAA	-0.30%
Switzerland	AAA	-0.33%
United Kingdom	AA	0.84%
France	AA	-0.05%
Italy	BBB	0.67%
Spain	BBB	0.33%
Portugal	BB	0.22%
Greece	B+	0.85%

Source: Bloomberg as of March 31, 2021

So, before we go any further, we want to make it clear that one of the first misconceptions about the ***possibility*** of materially higher interest rates is that we believe the ***probability*** of this occurring in the short-term is somewhat low due to the detrimental impact it could have on the U.S. economy. Nevertheless, we must acknowledge what the U.S. government has done over the past decade from both a fiscal and monetary standpoint does have the potential to stoke inflationary pressures. Accordingly, the risk of higher interest rates is real, albeit more so in the intermediate to longer term.

When interest rates rise, bond prices typically decline in value to reflect the higher interest rate environment. How much the bond declines is a function of what interest rate the bond is already paying, its credit quality, and how long until the bond matures. This combination of factors leads to dramatically different results in a changing interest rate environment. If you are concerned about higher interest rates it is important to understand what type of bonds you own to determine your potential return outcomes.

The most highly interest rate sensitive bonds are long-term U.S. government bonds. These bonds have very low yields due to their lack of default risk, thus even a small change in interest rates can cause these bonds to swing wildly in price. Case in point, during the first

quarter of 2020 fear swept through the financial markets due to the outbreak of the Covid-19 pandemic. This sent U.S. Treasury interest rates lower by more than 1% in a matter of days due to severe distress in the credit markets, resulting in a greater than 20% gain for long term U.S. Treasury bonds in short order. As market conditions returned to normal over the past year, interest rates have increased on these securities by nearly a full percentage point resulting in losses exceeding 10%. This return profile illustrates why long-term government bonds are the most interest rate sensitive segment of the bond market.

Over the same period of time the return of corporate bonds was much different. During the first quarter investment grade corporate bonds lost 3% of their value, despite U.S. Treasury interest rates going down. Conversely, they returned just under 10% since the March lows, despite U.S. Treasury interest rates going up. So, in 2020, when U.S. government bonds rose in value, most corporate bonds declined in value and vice versa. The point we are making here is to recognize that when interest rates go up or down, the performance of bonds is dependent upon what ***type*** of bond you own and ***why*** interest rates changed.

In this example you can see how a change in interest rates due first to financial market distress, followed by resurging confidence affected government bonds differently than corporate bonds. Next month we will address the next major factor driving bond prices in a changing interest rate environment…inflation.

Information for bond rates provided by www.bloomberg.com/markets/rates-bonds [2]

Categories:
Protecting my financial legacy [3]
Having the retirement that I want [4]
Corporate Professionals/Executives [5]
Making the most of my working years [6]
Professional specialists/service providers [7]
Business Owners [8]
Dentists [9]
Read More [10]

Source URL: https://www.brightworth.com/insights-news/will-rising-interest-rates-sink-my-bond-investments-part-1

Links
[1] https://mcgilladvisors.brightworth.com/team/jharrell#profile-main
[2] http://www.bloomberg.com/markets/rates-bonds
[3] https://www.brightworth.com/categories/protecting-my-financial-legacy
[4] https://www.brightworth.com/categories/having-retirement-i-want
[5] https://www.brightworth.com/categories/corporate-professionals-executives
[6] https://www.brightworth.com/categories/making-most-my-working-years
[7] https://www.brightworth.com/categories/professional-specialistsservice-providers
[8] https://www.brightworth.com/categories/business-owners
[9] https://www.brightworth.com/categories/dentists
[10] https://www.brightworth.com/insights-news/will-rising-interest-rates-sink-my-bond-investments-part-1