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The Recent Rise in Interest Rates

In May, comments from Federal Reserve Chairman Ben Bernanke unsettled financial markets. Mr. Bernanke stated that the Fed may start to scale back, or "taper," its bond purchases later this year. Under this program of "quantitative easing," the Fed buys $85 billion of bonds each month in an effort to keep long-term borrowing costs low, and generate a self-sustaining economic recovery.

Both bond and stock markets' initial response to this news was negative. The prospect of the monetary "tap" being turned down led to a retreat in global stock markets, a broad-based rise in bond yields, and a decline in some commodity markets.

Gold in particular was hit hard by the Fed's signals. The price fell 23% during the second quarter on the view that rising bond yields and a strengthening U.S. dollar would hurt the metal's appeal as a perceived safe haven.

There are several points to keep in mind as we consider these developments.

- We saw a classic example of how markets efficiently price in new information. Markets were not expecting these comments and adjusted accordingly.

- Investors should exercise caution regarding predictions on the likely path of interest rates in the wake of the Fed's latest signals. When the Federal Reserve began its second round of quantitative easing in late 2010, a group of 23 economists issued dire warnings about "currency debasement and inflation" in an open letter to the central bank.[1] Yet inflation in the U.S. is basically unchanged, and the U.S. dollar is higher than when those warnings were issued (see charts on next page).

  Basing an investment strategy around "expert" forecasts does not always work. Over the last several years investors who held cash, as higher interest rates were predicted, missed out on a period of strong bond returns.

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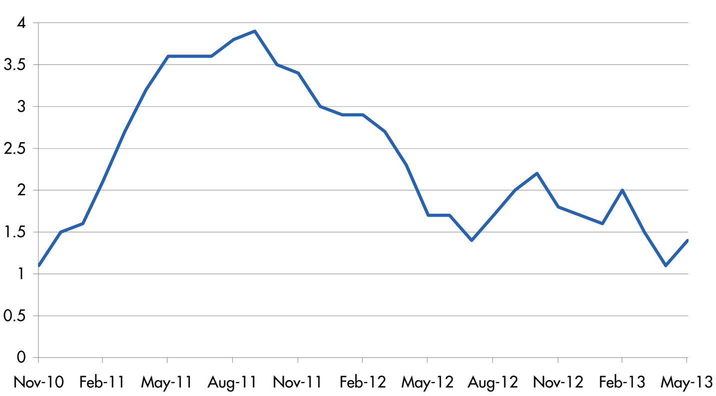
US Dollar Index

Source: Bloomberg

US CPI (Inflation) Year-on-Year



Source: US Bureau of Labor Statistics

- For all the people selling bonds, there are others who see value at lower prices and are buying. A fall in bond prices equates to higher expected returns. Selling bonds after prices have fallen echoes the habit of many stock market investors who buy high and sell low.

- Bonds are an important diversifier in a balanced portfolio. They help to moderate the volatility associated with stocks and provide income as well. Even though today's yields are low and return expectations are modest, bonds still play their traditional role. As we have discussed in prior *Journals*, bond portfolios should themselves be broadly diversified across several areas of the fixed-income markets.

- Having a conservative maturity structure will help to limit short-term losses, which should be recouped over time as funds invest in bonds offering new, higher yields. According to a recent Vanguard study, it may not take bond fund investors very long to recover principal lost due to rising rates.[2]

If interest rates were to increase by 1% over the course of one year:

- It should take 2.0 years for principal to recover for a short-term bond fund.
- It should take 2.2 years for principal to recover for an intermediate-term bond fund.

If interest rates were to increase by 2% over the course of two years:

- It should take 2.9 years for principal to recover for a short-term bond fund.
- It should take 3.5 years for principal to recover for an intermediate-term bond fund.

As losses are recovered, bond investors will benefit from a higher interest rate environment.

- Finally, keep in mind that volatility is often most unnerving to those who pay the most attention to the daily noise. Investors who take a longer-term, distanced perspective can see these events as just part of the process of markets doing their work. What investors can do is manage their emotions and remain focused on their long-term goals. Inevitably, second-guessing markets means second-guessing a solid long-term plan. It is long-term thinking that is most important in achieving goals over time, not short-term timing based on predictions or trends.

Sources

1. Floyd Norris,"Predictions on Fed Strategy that Did Not Come to Pass," *New York Times* (June 28, 2013).

2. These hypothetical examples are for illustrative purposes, do not represent any particular investment, and make the following assumptions: the portfolios start with an average duration of 2.7 years for the short-term bond fund and 5.3 years for the intermediate-term bond fund with average yields of 0.6% and 1.7%, respectively, and that all interest income is reinvested. For more information on this topic, see the Vanguard paper *Risk of loss: Should investors shift from bonds because of the prospect of rising rates?* (Philips, Kinniry, Walker, 2010). Source: Vanguard, Fixed Income Series, "Shortening maturities may help protect principal but could lower income," 2013.

Disclosures

This information is for educational purposes only and should not be considered investment advice or an offer of any security for sale.

Past performance is no guarantee of future results, and every investment strategy has a potential for profit or loss.

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