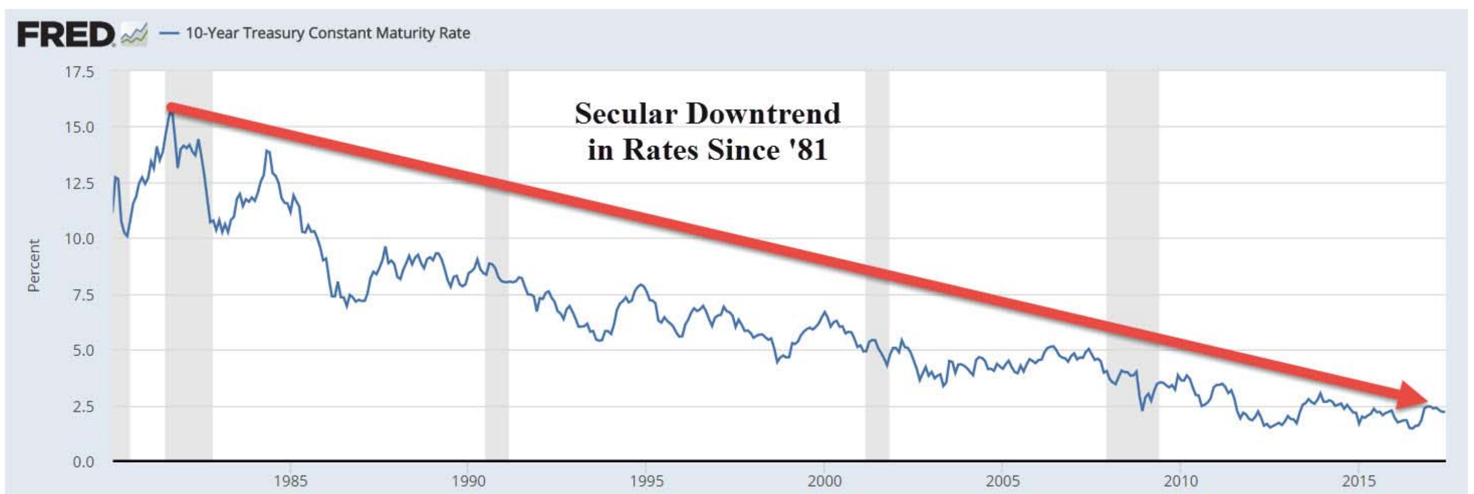
Bonds in a Rising Rate Environment

A conversation with Byron Green about his ETF-based bond strategy, Guardian Fixed Income™

Question 1: What does the future of U.S. interest rates look like?

Beginning with a 10-year U.S. Treasury yield over 15%, the long-term decline in rates since 1981 have been amazing. The elevated yields were the result of several years of persistently high inflation. Paul Volker, the Chairman of the Federal Reserve, is widely recognized as being responsible for successfully breaking the cycle of higher and higher inflation and much of the secular decline since then. More recently, the Financial Crisis of ’08, contributed to deepened declines in rates as central bankers of the U.S., Europe, England and Japan resorted to extraordinary monetary stimulus through quantitative easing and other means to head off a deflationary spiral. The extreme liquidity pushed the 10-year U.S. Treasury yield to a low of 1.32% in July of 2016. Recent evidence supports the idea that the deflationary episode is past and global economies appear to be growing together once again.

Recognizing the improvement in the economy, the Federal Reserve has been on a path of removing the aggressive accommodation, having raised the federal funds rate by 1% in ¼% increments since December 17, 2015. The gradual unwind of its balance sheet is expected to begin in the immediate months ahead. Since bonds bought into the Fed’s inventory contributed to lower interest rates, it seems unrealistic to expect the reversing of those purchases will not exert some upward pressure on interest rates. Improving U.S. and global economic growth combined with the advanced stage of the current economic expansion seem to point to higher rates ahead.



Board of Governors of the Federal Reserve System (US), 10-Year Treasury Constant Maturity Rate [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/DGS10, June 12, 2017

Question 2: Is that bad news for bonds?

It doesn’t have to be. As everyone knows, interest rate increases generally mean price declines for traditional high-quality bonds, especially those with longer maturities. Some bond funds that depend on buy-and-hold strategies could face difficulties in this type of environment. This would be a real sea change, since those are precisely the types of bond funds that have benefited by the secular decline in rates. If a new secular trend of rising rates is in fact at hand, an active and flexible management style should contribute to making bonds an advantageous place to invest.

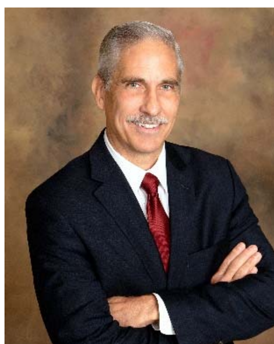
Our Guardian Fixed Income strategy is such a flexible fixed-income strategy that is tactically allocated in bonds between one end of the yield curve and credit quality spectrum to the other, commensurate with the economy's position in the interest rate cycle. We understand that during a period of rising interest rates duration works against you. In this environment, a portfolio of 30-year Treasuries is clearly not the way to go. Decreasing the duration of a bond portfolio makes price less sensitive to rate hikes. By pulling back on duration (or hedging or going to cash) when rates rise, then redeploying at the higher rates, the short-term challenge of rising rates can even become a long-term positive, with income to the portfolio growing.

High yield corporate issues can also be an excellent choice as interest rates rise. Their returns are generally more correlated to equities and the overall economy than to other bond classes. High yield corporate bonds show significant correlation to the S&P 500, but very little to intermediate or long-term Treasuries. Higher coupon payments can not only serve as a buffer against price losses, they can also provide positive return. While Treasuries are very sensitive to price changes, the gains from yield on high yield corporate bonds can dominate price loss.

Relative to Treasuries, high yields substitute credit risk for interest rate risk. This can be an especially advantageous trade to make when interest rates are rising and the economy is sound. Another important variable to consider when interest rates rise is geography. Some nations, may have stronger public balance sheets than the U.S. (less debt relative to GDP), which could diminish the overall demand for credit leading to lower or more stable interest rates in these countries. If rates rise domestically, such bonds can offer excellent diversification opportunities to investors.

"we seek to achieve growth and income with reduced volatility"

Rising rates can enhance the return from income. This brings the potential of overcoming capital losses when the bond portfolio is actively managed and management is free to move along the spectrums of duration and credit quality. That creates a significant advantage over portfolios that are restricted to Treasury and high-quality issues, where rates and therefore income are now so low. The result is a strategy whose value moves with the general economy and equities, not just interest rates. With Guardian Fixed Income we try to achieve growth and income with reduced volatility. I like the prospects for our flexible income strategy in the immediate years ahead.



Byron Green is the President of Green Investment Management, Inc.

The Guardian Fixed Income strategy is a diversified mix of exchange-traded (ETF) and other bond funds, primarily domestic but with a small allocation to foreign bonds as conditions dictate. It is a conservative allocation that may be suitable for clients desiring high income, safety and stability, such as those in or nearing retirement.

Disclosure: Please request Form ADV Part 2 for a complete description of Green Investment Management, Inc.'s management services (available on www.GIMlink.com). Investing involves risk. Interest rate predictions are not always accurate. There is no assurance that the strategy discussed herein will be profitable or will not incur loss. Investing in high yield securities may involve additional risks than bonds of higher quality, including, an increased risk of default. Investors should consult with their advisor and carefully consider their investment objectives and risk tolerance before investing.