SIGNATURE RESOURCES
CAPITAL MANAGEMENT

Commentary: March 2018

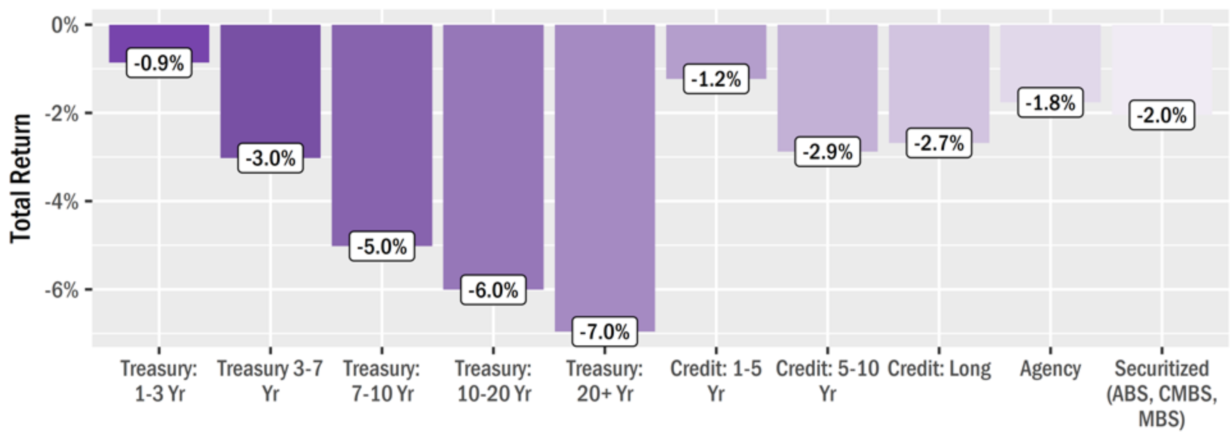
RISING RATE REVIEW

More than a few folks are worried that interest rates are on the rise. Leaving aside the fact that rising rates generally are a signal of an improving economy, the concern may be warranted given the fact that bond prices generally fall as interest rates rise. Here as in so many other facets of investments, though, the perspective of time matters. As yields increase, we look to the potential for income from bonds to offset capital losses (as bond prices fall), a feature facilitated by the now higher yields on those bonds. Those concerned about the medium-term effects of higher rates on the bond portions of their portfolios may find some solace in this month's review of past rising-rate periods.

Feeling the Pressure

Though the increased volatility of the equity markets has since stolen the headlines, fixed income investors late last year had begun to feel the effects of the current rising-rate environment. By that, we mean that prices on already-issued bonds fell as higher rates on newer bonds enticed buyers. As demand shifted, prices on older bonds fell until their yields caught up. Helps to think about the relationship like this: a bond's coupon, the interest it pays each period, generally is a fixed dollar amount. That interest, divided by the price of the bond is the yield. As the price of the bond falls, the coupon rises as a percentage of the bond's price (the yield). In Figure 1, we detail those pressures. Readers may recall that there are two primary risks to bond investing: interest-rate risk and credit risk (default). The U.S. Government being quite unlikely to default, the primary risk expressed in Figure 1 is interest-rate risk: generally speaking, longer-term bonds are more sensitive to changes in interest rates, and hence have seen relative underperformance more recently, versus shorter-term bonds. Corporate bonds have suffered less as a group, though, as the improving economy arguably has lessened concerns that the companies behind those bonds might default.

Figure 1: Bloomberg Barclays U.S. Aggregate: Sub-Sector Total Return

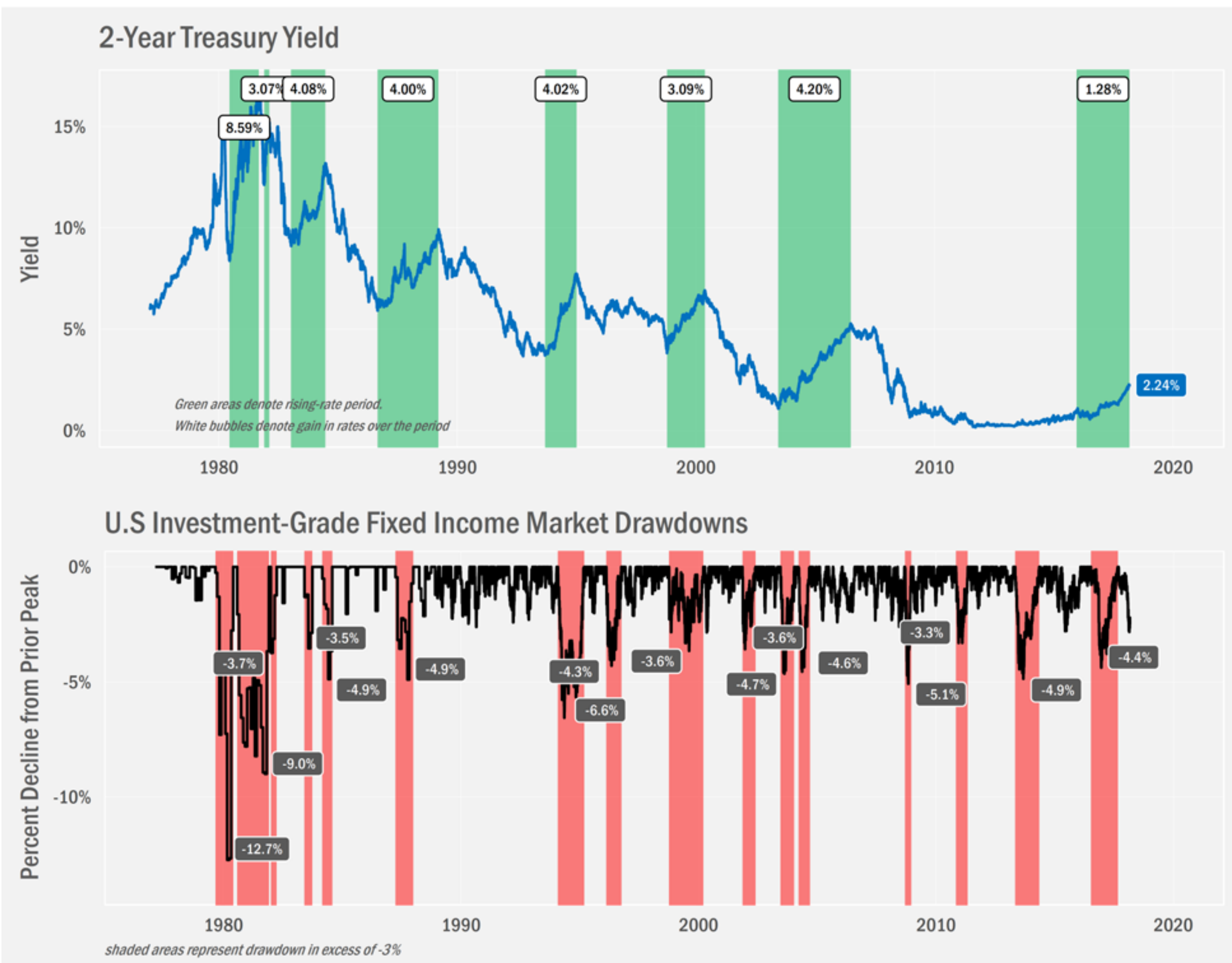


From 09.07.17 to 03.02.18. Past performance is not indicative of future results. Investing in securities involves risk, including risk of losing some or all the invested capital. There is no guarantee that any investment or investment strategy will achieve its objective. One cannot directly invest in an index. Index performance reflects the reinvestment of dividends, but does not reflect the expenses associated with the management of an actual portfolio. Please see additional important information regarding indexes at the end of this report. SOURCE: SRCM using data from Bloomberg

When Rates Fly

Past periods of rising interest rates have taken many forms. Some came quickly, while others proved more drawn out. The differences between the beginning (trough) and ending (peak) levels were moderate in some and large in others. As the definition of a rising rate period is open to interpretation, for the purposes of this review we chose to include those periods during which we saw an obvious long-term rise in the yield of the 2-year U.S. Treasury bond. We then marked the beginning as the near-term trough in the 2-year yield and the end as the near-term peak. These periods, highlighted in green in the top part of Figure 2, generally have coincided with times during which the Federal Reserve, such as is the case now, was reducing its accommodation of macroeconomic growth. The bottom half of Figure 2 displays the historical drawdowns of the broader U.S. fixed income market. Reinforcing the idea that rising interest rates generally are not so good for bond prices, one can see that each of the rising-rate periods contains at least one drawdown, with the worst found in the early ‘80s. Otherwise, a 5%-ish decline seems to have been the norm.

Figure 2: Rising Rates and Bond-Market Performance



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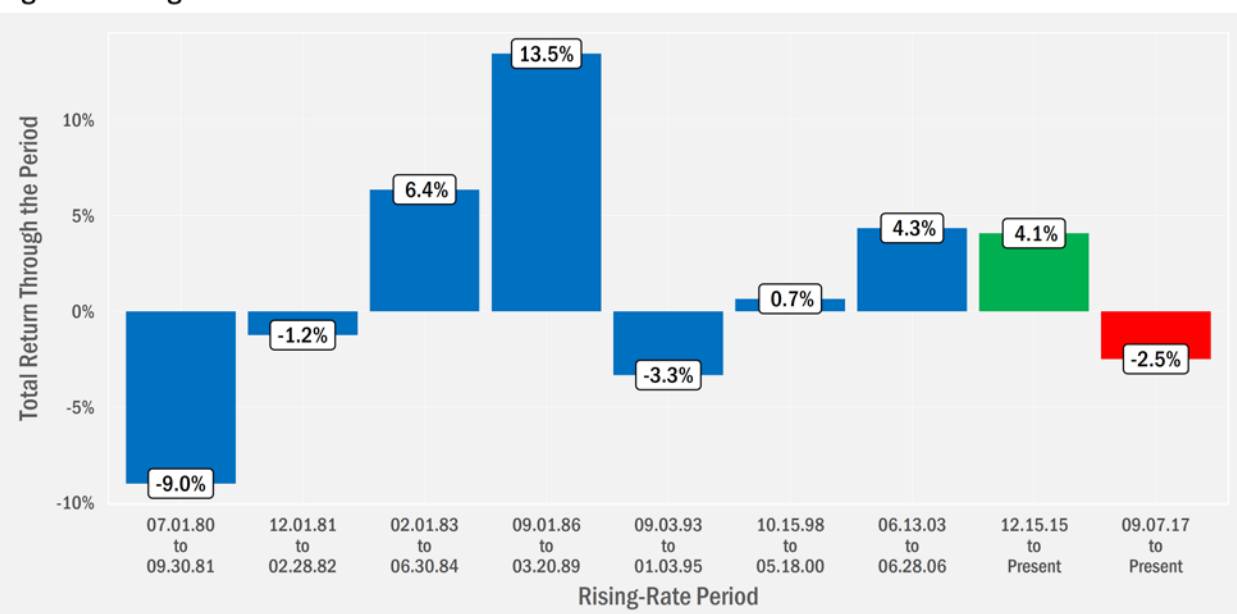
This Time…All Times…Unique

That sort of decline already has been experienced this period, too, depending on when one chooses the start date. Obvious in the chart, we could have marked the beginning of this latest period of rising rates a bit earlier. Or even a bit later, for that matter. That is, there is a slow ramp to the left of the green area starting in 2015 and then a bit of a dip right after the beginning. To demarcate this latest episode, we chose as the starting point the actual first time the Federal Reserve raised interest rates since the Great Recession, December 15, 2015. We did this to emphasize an important characteristic that we think generalizes bond market returns during rising rate periods. If we start at the near-term trough of the 2-year Treasury yields way back in 2011, total returns for the U.S. bond market has been positive. But, move the start a bit later and it's negative, on the order of about 2%. The upshot is that time seems to have healed nearer-term wounds during rising-rate periods.

Taking magnitude into consideration, when one compares them to historical equity-market drawdowns, fixed income market drawdowns have proved relatively tame. Of course, we should hope that's been the case, considering we choose to invest in bonds for their relative safety. A helpful reminder, nonetheless. Even more, when we look back at past rising-rate periods, we see that the fixed income market has fared not so poorly. In Figure 3, we chart the same eight rising-rate periods we showed in Figure 2. For some periods, we had to move the start and end dates to the first and last days of the month, as the benchmark offers only monthly date prior to 1989. And for the latest, we charted both the period described earlier, and the period since September of last year, when rates really started taking off (they're marked with the green and red bars on the right). Pointing back to Figure 2, we can see that in each case, with the exception of the present drawdown, the fixed income market recovered from earlier losses related to rising rates.

Figure 3: Rising Rates and Bond-Market Performance



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Of course, past performance is no guarantee of future results, but we hope that the review eases some of the concerns readers might have with regard to holding bonds now that rates are rising. And we'll remind readers again of the relatively lighter volatility bonds generally experience, versus equity. Those who might like to see some more data in this regard may wish to refer to our January 2017 commentary ("Returns Commensurate with Risk") in which we compare historical drawdown details in the U.S. equity and fixed income markets.

Looking Forward

It is impossible to determine in advance how long will last this period of rising rates, already unique for its drawn-out beginning, and to what extent we might see additional declines in bond exposures within our models. But, with time we think that the present decline will ease as the income from bonds—now a bit higher, given the now higher yields—begins to offset those price declines. Advisors are happy to discuss such considerations further with readers interested in learning more about our portfolio positioning, both presently and in the context of our broader investment methodology.

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The Bloomberg Barclays U.S Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. In this report, we refer to this index as the U.S. Investment Grade bond market ("IG Bonds").

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