5 | The Bright Side of Higher Yields

It seems illogical to argue that rising interest rates are not necessarily bad for bonds, but hear us out. For many individual investors, the simple concept of “bond prices fall when interest rates rise” can trigger a kneejerk reaction to sell or, at least, become leery of entering the fixed income space during a period of rising rates. Before we explain, let’s first take a look at the landscape thus far in 2018 and perhaps the question that it has prompted: why should I invest in bonds now?

**What is the current interest rate environment?** Interest rates have increased in a yield curve flattening manner this year, perhaps more quickly than market participants anticipated. The front-end of the curve is higher by approximately 70bps (.70%) while longer maturities are up by about 40bps (.40%) year-to-date. Front-end movement has been driven primarily by tightening monetary policy here in the U.S. (via Fed increases), while the intermediate to longer portions of the curve have drifted higher on modestly improved growth figures and expectations for rising inflation. From our standpoint though, while short-term U.S. growth (in part driven by fiscal stimulus) may improve somewhat in 2018, significant uncertainty still surrounds growth in the medium to longer-term. Also, while there has been a modest uptick in some price measures, we do not see outsized inflation pressures pushing intermediate and longer maturity yields meaningfully higher. A quick examination of the yield pickup between 10YR and 30YR U.S. Treasury bonds suggests that many market participants agree with our current assessment. As it stands now, there is only a 14bps (.14%) difference in yield between the two maturities, a low going back more than a decade and certainly not indicative of a market concerned about inflation.

**So why are rising interest rates not a bad thing?** First, it is important to remember Caprin constructs its client portfolios with capital preservation as a core tenant; an increase in interest rates alone does not necessarily mean a decline in portfolio value. Further, our intermediate municipal strategies, for example, are strategically positioned from a duration and maturity standpoint to help combat rising interest rates. Our experience and expertise in building core bond portfolios helps ensure clients have sound cash flow from both coupon income and future maturities that can be reinvested to capture improving yield levels. This portfolio characteristic is one of the most powerful offsets to rising interest rates and helps ensure that, when the tide turns and interest rates peak, the portfolio is fully invested at far better yield and income levels.

To help illustrate the importance of our portfolio construction and the power of reinvesting when interest rates are rising, please refer to the Table 1. Shown are the hypothetical total returns for several representative Caprin client portfolios with approximately 4.0, 4.25, and 4.5 year durations. We stress tested the portfolios over the course of 1 and 2 years to show what might happen if interest rates moved higher by as much as 150bps (.15%). We do not expect interest rates to move higher by 150bps, but this illustration shows just how resilient a well-constructed intermediate bond portfolio can be even when faced with higher rates.

**In conclusion.** While interest rates have risen in ’18 and may drift moderately higher as the Federal Reserve continues to tighten and near-term growth remains sound, we do not expect intermediate and longer-term rates to move substantially above current levels. For those investors thinking about reallocating assets, we view the current yield environment as a solid entry point. Absolute yields are as attractive as they have been in years, especially on a taxable equivalent basis for munis, and, whether it is beginning an allocation to core fixed income or increasing an existing allocation, we believe our conservative and deliberate portfolio construction coupled with the power to reinvest into higher rates should allow investors to be confident in today’s and tomorrow’s bond market.