Economic and Market Insights

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By Scott Colbert, CFA
Chief Economist, Director of Fixed Income
The Commerce Trust Company

Don't Fear the Rising Interest Rate Environment – Just Roll With It

Intermediate Bond Portfolio 1- to 10-Year Ladder of Maturities
Interest Rate Shocks
Total Return Scenarios - 12/31/2016

	NO CHANGE		GRADUAL: +0.25% per Year		INSTANTANEOUS: +2.50% in 1st Year	
YEAR	**Annualized**	**Cumulative**	**Annualized**	**Cumulative**	**Annualized**	**Cumulative**
1	2.1%	2.1%	1.2%	1.2%	-6.8%	-6.8%
2	2.1%	4.3%	1.3%	2.7%	-1.2%	-2.5%
3	2.1%	6.5%	1.5%	4.5%	0.7%	2.0%
4	2.1%	8.7%	1.6%	6.5%	1.6%	6.7%
5	2.1%	11.0%	1.7%	8.9%	2.2%	11.7%
6	2.1%	13.3%	1.8%	11.6%	2.6%	16.8%
7	2.1%	15.7%	2.0%	14.6%	2.9%	22.2%
8	2.1%	18.2%	2.1%	18.1%	3.1%	27.8%
9	2.1%	20.7%	2.2%	21.9%	3.3%	33.7%
10	2.1%	23.2%	2.3%	26.1%	3.4%	39.9%

Source: Barclays Gov/Credit Intermediate Index 12/31/16. Yield: 2.11%, Maturity: 4.39 yrs. In the "No Change" column, the chart shows how maintaining an intermediate bond portfolio for 10 years would perform for the bondholder if interest rates remain unchanged. Note the cumulative return over 10 years reaches 23.2% in year 10. In the "Gradual" column, where the Fed slowly raises rates 0.25% per year, the same intermediate bond portfolio reaches a 26.1% cumulative return by year 10. In the last column, the chart shows how an instantaneous 2.50% interest rate spike across all maturities in year 1 hurts investor return dramatically at the outset, but recovers quickly until reaching a 39.9% cumulative return in year 10.

With interest rates as low as they are today, bond fund investors are rightfully worried about what could happen if (or when) interest rates begin to rise.

As most investors know, when interest rates rise, bond prices decline immediately. Less understood, however, is that as interest rates rise, the reinvestment of all other monies compounds at those higher rates, over time offsetting the decline in bond prices.

For an investor in an intermediate bond portfolio, projected cumulative returns are 23.2% over the next 10 years if interest rates remain at today's levels. But if rates begin to rise gradually, cumulative return picks up to 26.1% with no negative annual return.

And, amazingly, if rates spike up immediately, your return increases to 39.9% as higher coupons (periodic interest payments a bondholder receives) offset the initial negative return by year three. Ironically, bond investors should be "rooting and cheering"for higher rates rather than fearing them. This is why we do not encourage investors to abandon the bond market or to move materially short in maturity with their investment allocation.

Takeaways:

- While a bond's value may temporarily decrease during the rising interest rate environment predicted for 2017 and 2018, funds reinvested in a fixed income security at the higher interest rate generally offset the bond's price decline over time.
- Bonds often play an important role in a well-diversified portfolio, providing both predictable income and principal protection.
- Talk to your Commerce financial advisor when considering fixed income investments appropriate for your particular circumstances and portfolio allocation.