

Interest Rates are Trending Up. Should you care?

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While the Syria situation has taken center stage in the news, it won't be long before the rise in interest rates becomes headlines again. So, if you haven't already, you will soon be hearing alarming reports of the "dramatic rise of Treasury bond rates," and the breathless implication in the articles and on the financial cable programs about how this will have a disastrous effect on bond owners and the economy in general. Higher interest rates! More inflation! Lower economic growth! More interest on the ballooning federal debt! More competition for the stock market, and therefore lower stock prices! Egads, what's an investor to do with their bond portfolio? (Besides work with a reputable financial advisor.)

Well, first, if you look at the recent rise in 10-year Treasury rates in isolation, as several commentators have done, it does indeed look remarkable: a rise of more than 70% from a May 2 low of 1.63% to somewhere in the neighborhood of 2.90% as you read this (an increase of about 1.3%, but a HUGE increase in percentage terms nonetheless). If the Dow were to jump that far, that fast, on a percentage basis, it would have risen from 14,500 to more than 25,500. Yikes! Maybe the headlines are justified after all!

But if you put the recent rate rise into a longer-term perspective, the recent "dramatic rise" looks awfully puny compared with some of the long-term swings in market history, and the current rate still looks quite low. The high percentage shift is more a reflection of how low rates had gotten than a rise to dramatic heights.

So what's really going on here? Nobody knows when the Federal Reserve Board is going to stop buying Treasuries, or what, exactly, will happen when the elephant jumps off of the see-saw. The Fed's most recent meeting minutes suggest that it will be cautious about winding down its QE bond buying program. And you can bet that Fed economists will be watching the market for signs of impending damage, and curtail their curtailment if they seem to be causing a ruckus. But that still leaves a bit of uncertainty about where rates will go.

All professional investors know for sure is that when a big buyer (i.e. The FED) walks away from the marketplace, gradually or not, there will be less demand for whatever they were buying than there was before. Therefore bond issuers--including the U.S.--will have to pay more (i.e., higher yields) to lure in the fewer remaining buyers.

How much more will they have to pay? In other words, how much higher will bond rates go? How much will the bonds you own today lose value during the messy

pullback from the QE stimuli? We can make this second question easier to answer by simply pulling money back away from longer-term bonds until the dust settles, leaving it to the experts and institutional buyers to make educated guesses and read the tea leaves. None of the advisors I know are purchasing longer term bonds (i.e. 10 year maturities and greater).

But you have to answer the first question in order to know the answer to the obvious third one: what other consequences will rising bond rates have on your other investments?

When market forces get back in control of the bond markets, they will be responding to three things:

1. How scary are the alternative investments (and therefore how much do I want to put in bonds)?
2. What is the current and expected inflation rate? (And which assets have the best chance of beating inflation.) And finally:
3. Where do I want to be on the yield curve (long versus short term rates)? (Are the longer-term rates attractive enough to lure you away from the relative safety of shorter-term bonds?)

Right now, inflation is pretty low, in part because the high joblessness rate is making it harder for workers to ask for huge raises, in part because the banks have a lot of money to lend and not a lot of people are asking to borrow it. A recent report notes that an astonishing 82% of the U.S. money supply is currently on deposit at the Fed, mostly in accounts held by large banks. (To put that in perspective, the average percentage from January 1959 through the end of 2007 was 6.18%.) By the laws of supply and demand, banks don't have a lot of leverage to demand high rates of interest.

If you believe that the unemployment markets are going to tighten up dramatically in the fairly near future, and that somehow millions of people will want to borrow most of the global supply of dollars, then you can project a high inflation rate. If not, then you should probably not worry about an explosion in the inflation rate for the foreseeable future.

When we're talking about alternatives to bond investments, we're mostly talking about stocks. If we see another Fall of 2008 scenario, people are going to flock to government bonds and drive rates higher. But the only thing we know about the Fed's decision-making process, from its notes and internal policy debates, is that it is only going to start exiting its QE program when it thinks the economy is healthy. If the stock market starts to look edgy, or the U.S. starts sliding back into recession, you can bet that the Fed

will want to keep interest rates low and be a tad more gradual about ending its QE activity.

As to the yield curve, at the moment, short-term rates on Treasuries and most other fixed-income vehicles are about as close to zero as you will ever see them again. The Fed has announced that its policy rate is 0%, and until the economy gets fully back on its feet and unemployment comes down dramatically, this is likely to continue to be its policy rate. The spread between 3-month T-bills and 10-year Treasuries is currently about 2.8%, which is nearly twice as high as the 1.5% historical average. Can it go higher? Yes. On two occasions since January of 1970, the spread has reached as high as 4%.

If you add up all these clues, you come out with something very different from the disaster scenarios you'll be hearing in the news. The Fed is planning to reduce and then stop buying Treasuries at some point in the future, and let market forces take over--but only when it feels like the economy is healthy, and only so long as it can do this without harming economic growth or hammering the stock market. It will be a gradual process, not an overnight phenomenon. The market forces themselves are unknown, but it's hard to see how the ten-year Treasury bond will rise above 4%--or, to put THAT number in perspective, to the point where it is yielding about twice the dividend yield in the overall S&P 500 index. That still looks like pretty weak competition for stocks.

So what we're actually seeing in the bond market appears to be nothing catastrophic. Bond investors are demanding an extra 1.3% a year (so far) to compensate for all the uncertainty they face as they commit their money for the next ten years. They may well ask for a bit more in the future. Can you blame them?

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