Reality of Rising Rates

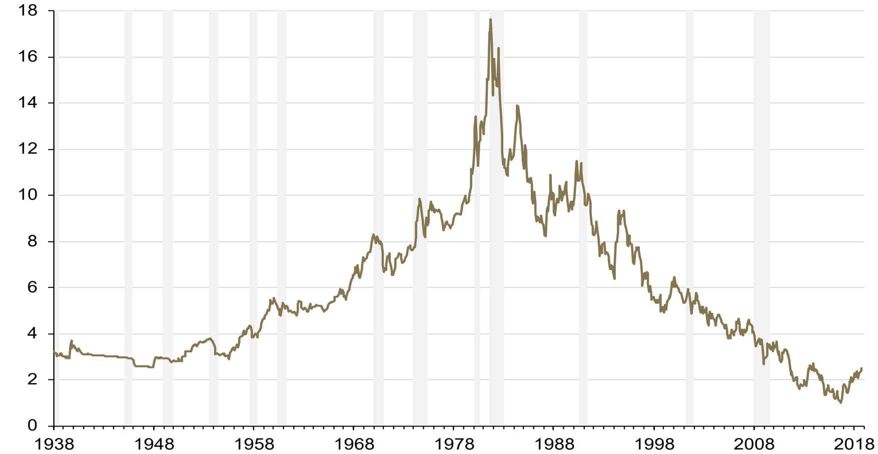
Long-time investors in government bonds, the asset typically viewed as “risk free”, may have noticed something unusual about their returns of late: negative numbers.

For three and a half decades, government bonds generated solid performance for their holders, with 10-year bonds recording annualized returns of 10% over the 35 years from September 1981 through September 2016, against the secular decline in yields (bond prices move inversely with market interest rates).

Interest rates, however, have stopped declining. In fact, they have actually been rising for two years now — benchmark 10-year yields bottomed in the aftermath of the Brexit vote in the summer of 2016, and while the initial ascent was modest, the increases have become more notable this year. As a result, those 10-year bonds that previously generated double-digit returns have created losses at a 5% annualized rate over the last two years.

The temptation may be to look through the performance over the last 24 months, given the experience of the previous 35 years. However, this recent period is likely to be more representative of what lies ahead.

Interest rates have not always been a one-way street
10-Year Government of Canada Bond Yield
(percent)



Shaded regions represent periods of US recession
Source: Statistics Canada, Guardian Capital

While investing in government bonds has been a positive experience for almost all current investors, given that interest rates have only really ever declined over their investing life, a longer-term perspective drives home the fact that yields can in fact, rise on a persistent basis as well.

Rising rates, however, are likely less the exception and more the new rule. Global central banks are increasingly removing monetary stimulus against indications of sustained economic growth and rising inflationary pressures.This means that policymakers are moving rates up from emergency lows and taking steps toward trimming balance sheets to pre-crisis levels.

While this process of normalization is likely to be gradual and face some bumps along the way, it still means that interest rates across the globe are likely to move higher, not lower. Given the current still-low yields, there is not much by the way of cushion for bonds against a rise in interest rates — all it takes is another 25 basis point increase in 10-year yields to push the 12-month total return to zero, and the yield has already increased by almost double that since June.

Importantly, though, while bond performance is likely to be impacted by rising interest rates, fixed income securities play, and will continue to play, an important role in the asset mix of a well-diversified investment portfolio. The risks over the outlook suggest that the volatility buffer provided by their steady cash flows and imperfect correlation with equities will be of increased significance over the coming months. Further, as pressures causing rates to rise eventually abate, patient bond investors will reap the benefits.

Accordingly, this is not a call to abandon the asset class but instead to be more cognizant of the risks associated with securities that have generally been viewed as having none, and take a more active approach to managing bond holdings in the near-term than has typically been necessary.

An oft-repeated phrase by investment advisors is that past performance does not guarantee future results and this is increasingly pertinent with respect to fixed income exposures in the rising rate reality.