Our Perspectives: Rising Rates — The Story of the Year, for Years

Expert Insights from RE Advisers

This article was prepared in December 2015 and appeared first in the Q4 2015 issue of *Horizons*, Homestead Funds' quarterly newsletter.

Fund Management and Profiles

Doug Kern, CFA

BS in Business Administration and MBA in Finance, Pennsylvania State University. Doug has been with RE Advisers since the company's launch in 1990.

The Short-Term Bond Fund (HOSBX) is managed to earn a competitive level of interest income, consistent with a low level of share-price volatility. At least 80% of the fund's net assets are invested in bonds that are in the three highest credit categories. The fund can hold U.S. government securities as well as corporate bonds and other types of debt instruments. Under normal circumstances, the fund's weighted average maturity is expected to be three years or less.

The Short-Term Government Securities Fund (HOSGX) is managed to earn a competitive level of interest income, consistent with a low level of share-price volatility. The fund's primary holdings are securities whose principal and interest payments are guaranteed by the U.S. government, such as U.S. Treasury bills and notes. Government-guaranteed issues pose limited risk of default: If the issuer were unable to make payments, the government would. But the fund's yield and share price will fluctuate, reflecting changes in interest rates. Under normal circumstances, the fund's weighted average maturity is expected to be three years or less.

Some days, it feels like the markets have been talking about interest rate increases forever. Now that the time has finally come, we anticipate some anxious market adjustments around the early months of rate hikes.

Yet, our portfolio managers argue that rising rates do not spell doom for short-term bonds. Below, portfolio manager Doug Kern shares his perspective on rising rates and the implications for bond investors. Doug's remarks were prepared as of December 17, 2015.

Q. Let's start at the beginning. When someone talks about policymakers raising interest rates, how do they do that exactly?

Well, there are several different mechanisms. Historically, the main one for markets is the **federal funds rate,** which is the rate that banks charge each other for overnight loans to meet daily reserve requirements.

The Federal Reserve influences this rate by announcing a target zone and then buying or selling government securities on the open market to drive the rate to its target. If the Fed wants the rate to rise, it sells securities, which lowers the supply of reserves in the banking system and thus increases banks' borrowing costs. It would buy securities — and payments would increase bank reserves and lower borrowing costs — if it intended to push rates lower. In the financial crisis, the Fed took this rate all the way down to a 0-0.25% range.

There are other tools, like the interest rate on excess and required reserves for banks, or the use of reverse repurchase agreements with money market funds. But the federal funds rate is usually the primary tool. Today, the Fed is on a path to slowly raise the federal funds rate off zero and into a more normal long-term zone.

Q. How does that affect other interest rates in the market, like a bank savings account or a mortgage or the bonds in a client portfolio?

All interest rates are connected, because borrowers have to compete for money. When the federal funds rate goes up, other short-term rates generally rise. Longer-term interest rates also tend to drift up, as the market anticipates a higher short-term rate in the future.

Now, though all interest rates are connected, they don't all respond to policy changes at the same speed. Things like U.S. Treasury bonds, agency bonds and corporate bonds respond quickly to changes. In fact, their rates start to go up as soon as the market anticipates a change. Mortgage rates from banks go up in short order; bank deposit and CD rates go up more slowly.

For the kinds of bonds that we hold in our portfolios — liquid, short-term debt from investment grade issuers — those rates respond very quickly to market changes.

Q. What's the usual scenario that causes policymakers to raise interest rates?

Typically, policymakers raise interest rates, also known as "tightening" monetary policy, to slow down an overheating economy. The Federal Reserve usually heads down this path when wages or other sources of inflation are moving upward too quickly.

The most extreme example of this is probably the 80s, when then-Chairman Paul Volcker raised rates. The federal funds rate hit a peak of 20% in late 1980 and early 1981 and finally put a stop to the high inflation of the 70s and early 80s.

Q. But inflation isn't the biggest worry today. What's different?

The current market environment is unusual because rates have been held near zero for seven years. What's more, the economy has recovered in such a slow and protracted process that the overheating phase is not yet taking hold. Inflation pressures remain low, especially with weakness in commodities, which feeds into lower energy prices.

So this period of rate hikes is in uncharted territory. Rates have never been this low for this long. And policymakers have never started these rate hikes with inflation levels this low. But today, the goal is not to slow down the economy, but rather to bring rates back into a more normal zone without damaging good economic growth.

Q. So inflation and economic growth are two of the big factors for rates. How do you see those metrics changing over the medium term?

This is where it gets tricky. The Fed wants to see continued improvement in the labor market towards "full employment," and steady inflation around its preferred level of about 2% annually. Let's talk about the best-case scenario for the economy: commodity prices stop falling and start to recover, generating inflation. And economic growth, not just in the U.S. but eurozone, China, Japan, also strengthens more than expected. Domestic wages, which are showing signs of going up, gather steam and go up at a 3-3.5% annual rate. If these things happen, we would expect a faster pace for rate increases, even potentially up to the Fed's projected 3.5% final destination for the federal funds rate.

Now the worst-case scenario: commodities are stagnant or continue to fall. The labor market weakens and wages stagnate or fall. And global growth stumbles or even contracts. In this case, we would expect a halt to the rate increases. The Fed is very wary of deflation, and would not want higher rates in that environment.

We expect something in the middle – slow inflation percolating from recovering commodities and wages, muddling economic growth around the world. In this case, we expect slow and careful upward moves for rates.

"All interest rates are connected, because borrowers have to compete for money. But not all rates respond to policy changes at the same speed."

Homestead Funds

Q. Let's talk about bond portfolios. When rates go up, how much does that impact the prices of existing bonds in portfolios?

Generally, when rates go up, the prices of existing bonds do go down. This effect is most pronounced on the longest-term bonds, like 10- or 30-year bonds.

But a change in bond price — the appreciation or depreciation — is only one component of total return for a bond or a bond fund. For a diversified and short-term bond fund like ours, those price movements are a very small fraction of total return. Most of the return over long periods comes from income, the coupons paid on bonds. This is true even when rates are climbing. We can look at a bond benchmark for an example of how this works. Over time, the vast majority of returns from bonds come from the coupon income, while price changes contribute much less to returns [see figure].

Q. What are the other effects of interest rate increases, besides bond prices?

Higher interest rates imply a higher cost of borrowing for companies, especially for the "riskier" enterprises out there. As these riskier companies bear a higher cost of capital, that can change their balance sheets and cash flow dramatically, even leading to default for some issuers.

"We expect something in the middle – slow inflation percolating from recovering commodities and wages, muddling economic growth around the world. In this case, we expect slow and careful upward moves for rates."

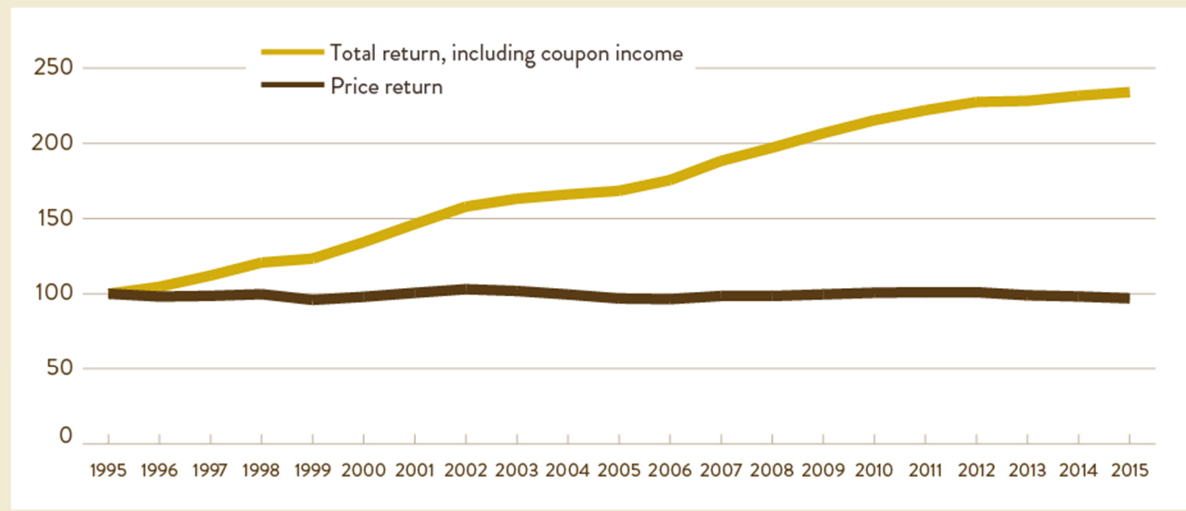
For instance, some sectors have really struggled because of low commodity prices, like oil and gas firms or miners. Some of these firms are already facing cash flow problems; higher borrowing costs can be the straw that breaks the camel's back.

This is certainly not true for all issuers. Banks, for instance, have better positioning in higher interest rate environments, because their revenues go up, but as we noted, the rates they pay out on deposits go up more slowly. As we assemble a portfolio, these are the considerations for selecting a mix of issuers.

Over Time, Income Dominates

There are two components of a bond's return: income and price changes. For short-term bonds, income typically comprises the lion's share of returns, as the chart below illustrates.

Total return (including coupon income) versus price return for the BofA Merrill Lynch 1-5 Year Corp/Govt Index



Source: Bloomberg. Total return assumes reinvestment of coupon income.

The BofA Merrill Lynch 1 — 5 Year Corp/Govt Index measures the performance of U.S. government and investment-grade corporate debt. Indices are unmanaged and investors cannot invest directly in an index. Unless otherwise noted, performance of indices do not account for any fees, commissions or other expenses that would be incurred. Returns do not include reinvested dividends.

Homestead Funds

Q. Does the outlook for rising rates change the role of bonds in client portfolios?

Bonds still play a crucial role in portfolios. The total return from bonds is really about the income, over long periods, and that steady income is what makes returns less volatile for most bonds than for things like stocks.

For many clients, bonds are a way to preserve wealth while earning income to offset inflation. Many investors who choose stocks for growth also want to mitigate some of the stock market's dramatic moves, and bonds do an important job of offsetting volatility. Even in a rising rate environment, the case for bonds is strong.

Investing in mutual funds involves risk, including the possible loss of principal. Investors are advised to consider fund objectives, risks, charges and expenses before investing. The prospectus contains this and other information and should be read carefully before you invest. To obtain a prospectus, call 800-258-3030 or download a pdf at homesteadfunds.com.

Homestead Funds client services team would be happy to talk with you about your goals and current investment program. Give us a call at 800.258.3030.

Past performance does not guarantee future results.

Investments in fixed income funds are subject to interest rate, credit and inflation risk. Interest rate risk is risk that a change in rates will negatively affect the value of the securities in the fund's portfolio.

Equity funds, in general, are subject to style risk, the chance that returns on stocks within the style category in which the fund invests will trail returns of stocks representing other styles or the market overall.

The views expressed in this market commentary are those of the individual as of the date noted and may have changed since that date. The opinions stated may contain forward-looking statements and may discuss the impact of domestic and foreign markets, industry and economic trends and governmental regulations of the funds and their holdings. Such statements are subject to uncertainty, and the impact on the funds might be materially different from what is described here.

Homestead Funds investment advisor, RE Advisers Corporation, and distributor, RE Investment Corporation, are indirect wholly-owned subsidiaries of NRECA.

RE Investment Corporation, Distributor. 1/16