Our Perspectives: Why Investors Should Cheer Higher Rates

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On the path to get interest rates back to "normal," we appear to be approaching the midway point between record lows and the terminal rate implied by Federal Reserve forecasts.[1] We hope by now it's apparent to investors that rising rates are not necessarily a bad thing. In fact, we see considerable benefits, particularly for those investors positioned in high-quality, short-duration fixed income portfolios like those we manage at Homestead.

The dangers of rising rates all lie in the journey, not in the destination. We expect bumps along the way, but it's in the interest of nearly all stakeholders in the bond market to see this transition progress slowly and smoothly. Here, we offer five reasons why investors should cheer higher interest rates.

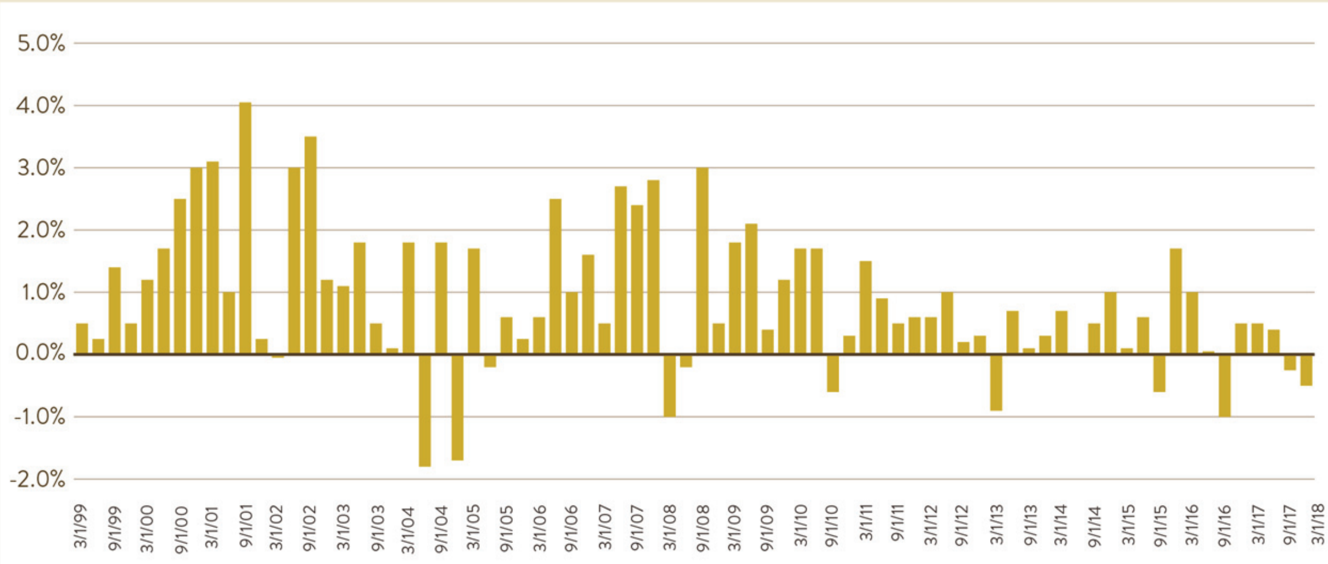
REASON 1: Bonds can do their job in high-rate and low-rate environments.

The role of fixed income in a portfolio is the same whether interest rates are 0.5% or 5.5%. There are few substitutes in the investment universe for fixed income securities, in terms of an option that primarily preserves capital plus offers some small compensation for the lender. Though bond prices can go down in certain market environments, historical losses are far milder than those of any other investment option besides cash. Indeed, for most investors, fixed income is something of an enabler. Because some portion of assets is relatively steady and safe, the rest of savings can be put at higher risk, invested in stocks and other investments with long-term return potential that carry the possibility of short- and medium-term losses. (Figure 1)

[1]https://www.federalreserve.gov/monetarypolicy/files/ fomcprojtabl20180321.pdf

Figure 1: Diversified mixes of high-quality bonds rarely post significant losses.

Quarterly Returns of the ICE BofA 1-5Y U.S. Corp/Gov Index



Source: Bloomberg

The ICE BofA ML 1-5 Year Corp./Gov. 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.

REASON 2: More income!

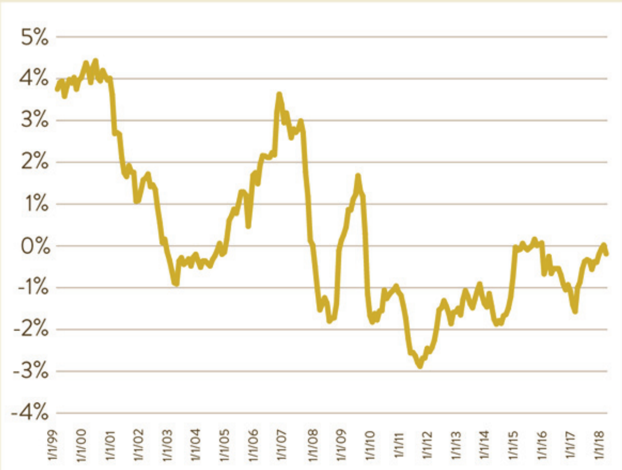
When interest rates rise, that does put pressure on the prices of existing bonds. But once the damage is done, so to speak, the expected total return of bonds on the market is higher going forward. What's more, new bonds are issued with higher coupons, locking in a new higher level of income over time. In the context of a fully invested mutual fund, the cash generated by bonds (either from coupons or principal repayment) is always being reinvested at the prevailing market rate. All told, higher rates sting for the period when the rate change occurs, but then provide a higher level of income going forward. As an added benefit, bonds issued with higher coupons have a lower duration (price sensitivity to interest rate changes) than equivalent zero-coupon or lower-coupon bonds, precisely for the reason that cash coupon payments over time soften the blow of an interest rate increase.

REASON 3: Normalization is good for investors.

Investors who have been around for a decade or two will recall that in earlier eras, the real rate of return was higher than it has been since the financial crisis. That is, the interest rate for bonds and even retail banking options (like certificates of deposit or savings accounts) was not only higher nominally, but also offered a higher real rate of return – the compensation to investors above and beyond the rate of inflation. But then the Fed slashed rates to near zero during the financial crisis. Once the crisis had passed, they left rates low to avoid snuffing out the early buds of economic growth – which meant the nominal rate was at or even below inflation levels. The result? Little or no real return. Now that rates are climbing into a more typical nominal zone, investors can begin to hope for a more typical real return as well. While we can't promise that markets will recover to the historical levels of real return, at least we can hope they trend in that direction as the Federal Reserve normalizes rates. (Figure 2)

Figure 2: Real yields have been mostly negative since crisis.

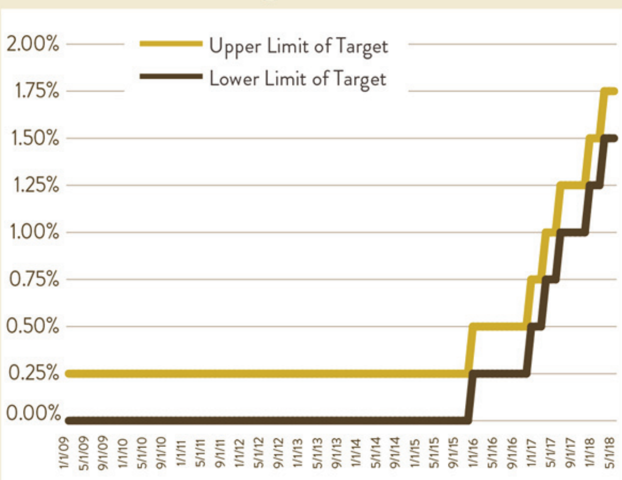
Real Yield of 1-Year U.S. Treasury (After Inflation), Calculated as PCE



Source: Federal Reserve Bank of St. Louis. Inflation measured by personal consumption expenditures (PCE), the Fed's preferred measure. PCE is the primary measure of consumer spending on goods and services in the U.S. economy.

Figure 3: With interest rates off zero, the Fed again has room to slash rates if needed.

The Federal Reserve's Target Fed Funds Rate



Source: Federal Reserve Bank of St. Louis

Policymakers, bond issuers and investors all want a calm fixed income market.

REASON 4: Normalization is good for the economy.

Interest rate targets are the "tool of choice" for the Federal Reserve in managing risks to the economy and to the financial system. As the target rate stayed close to zero for many years post-crisis, investors had to consider the possibility that another cyclical recession or systemic shock would come along before the Fed had the chance to bring rates back up. With rates finally off zero and headed north, the Fed once again has its preferred tool at the ready if (or when, rather) the next downturn strikes. (Figure 3)

REASON 5: Escape the higher-risk trade.

Amid record-low interest rates, many savers have taken on additional investment risk to maintain a certain level of interest payments or dividend income in portfolios. Some have invested in longer-term instruments, increasing duration risk, while others have gone to bonds with lower credit quality, increasing credit risk. Still others have left debt markets altogether for investments with far higher historical losses and volatility, like stocks, real estate investment trusts and master limited partnerships. However, to return to our first reason, fixed income securities usually performs a very specific job in the portfolio – capital preservation. Higher return options always come with higher risks, and a severe downturn in the markets would certainly punish those investors who remained invested in such higher-risk trades. As we approach a new era where higher quality fixed income securities can also provide a more normal yield, we see an opportunity for investors to restore portfolios to a more appropriate and conservative allocation.

Aiming for an uneventful journey

Policymakers, bond issuers and investors all want a calm fixed income market. Fed officials can never be perfectly accurate in their predictions about the future – in this market cycle, we've seen them tending toward overly optimistic projections. Still, they have stuck to their protocol in terms of announcing their intentions and following through operationally. When markets stumbled on the oil price collapse in late 2015, the Fed did pause rate-hike actions for an extended period. In recent quarters, we've seen growth become more broadly established globally, and inflation readings at a sturdier level.

What is a "normal" interest rate?

The Fed aim for a steady state inflation rate of

2%

PER YEAR

Historically, real returns are in the zone of 1-2% per year, for top-quality bonds like U.S. Treasurys. Adding those two components together, a "normal" nominal interest rate would be in the 3-4% band. The Fed is currently projecting a terminal rate of about 3 - 3.5% for the fed funds target, an overnight interest rate. From that anchor point, annual interest rates on longer-dated debt instruments tend to be higher to compensate for term risk.

Not every rate hike is created equal, either. Thanks to the effect of duration, rate hikes tend to have the biggest effect on prices when rates are at their lowest levels – a period that is behind us. When rates are at a slightly higher place, a small increase is more likely to be offset by coupon income in any individual period. As long as the rate hike process is slow, it can be completed without creating too many shock waves through markets.

There's also the question of how higher interest rates affect the economy, not just the prices of investments. In theory, higher rates can be a headwind to consumers and companies. Higher rates may dampen demand for mortgages and thus pressure the housing market, or raise the cost of financing for debt-heavy companies like utilities. But we'd argue that the target rate environment the Fed is aiming for – where "normal" rates are in the 3-4% range – is not extreme enough to serve as a major shock to consumers and companies that are otherwise economically sound. In fact, higher rates are good for things like bank profits, as net interest rate margins improve.

Ultimately, when we consider the issue of rising rates today, it strikes us that the early uncertainties are resolved, and the outlook is relatively stable. We think it's time for investors to retire their higher-rate worries, and look for the benefits that are available to them in a more normal interest rate environment.

Easing the shock with shorter relative duration

In a market where rates are rising, portfolio positioning can help soften the blow to investors. For a number of years, we have positioned our bond investments with a shorter average duration than that of their benchmarks. As such, our funds tend to outperform in environments where interest rates are rising, and may underperform at times when interest rates are falling.

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.

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