If Interest Rates Rise, What Happens to Bonds?

Investors in longer-term Treasuries could really be punished.

Are bond investors facing the possibility of major losses? Recently, bond yields have climbed. From November 1-23, the 2-year Treasury yield went from 0.83% to 1.12%, while the yield on the 10-year note rose from 1.83% to 2.36%.[1]

Quality bonds have a place in a portfolio, but many investors are moving their money elsewhere. They see a federal stimulus ahead in 2017, one that could potentially strengthen the economy and lead the Federal Reserve to gradually tighten interest rates. Assuming that happens and appetite for risk remains strong, what will happen to bonds and bond funds when rates begin to climb?[1,2,3]

The impact of rising rates will vary. Bonds and bond funds are different animals; some might even call them different asset classes.

In a rising-interest-rate environment, bond fund investors commonly see principal values decline until rates level off or dip again. The more intermediate-term and long-term bonds a fund holds, the bigger the hit it may take. A diversified bond fund will reinvest interest payments into new bonds with higher coupons, however – meaning investors will see larger returns with time.[2,3]

Long-term bonds tend to be hit harder by higher rates. They may lose market value, but eventually the higher rates will result in extra income for the patient investor.[2,3,4]

How about short-term and intermediate-term bonds? Some analysts warn against purchasing short-duration Treasuries and municipal and corporate bonds, contending that these debt securities might be hurt the most should the pace of rate hikes quicken. Others disagree.[2,3,4]

Higher rates have not always imperiled the bond market. Before December 2015 (when the Fed decided to raise rates again), the economy had seen six rising interest rate environments in 40 years. Those periods lasted from two to five years, with T-bill rates rising between 2.3-11.9%. In those six instances, the total annual return for the Barclays U.S. Aggregate Bond Index (the S&P 500 of the bond market) ranged from 2.6-11.9%, with most of the total annual returns at between 4-6%. In short, no disaster for a bond investor.[2,4]

Still, if the federal funds rate rises 3% over a period of a few years, a longer-term Treasury might lose as much as a third of its market value as a consequence – and if bulls happen to run on Wall Street with only brief retreats between now and 2025, how attractive will a short-term or intermediate-term Treasury be?

What if you want or need to stay in bonds? Some bond market analysts see merit in exploiting short-term bonds with laddered maturity dates. The trade-off: accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities if rates rise. If you are after higher rates of return from short-duration bonds, you may have to look to bonds that are investment-grade, but without AAA or AA ratings.[2,3,4]

If interest rates begin heading north soon, exploiting short maturities could position you to get your principal back in the short term. That could give you cash, which you could reinvest as interest rates presumably go up further. If you primarily see pain ahead for bond owners, you could consider limiting yourself to small positions in government bonds, investment-grade corporate bonds, and bond funds with durations of 10 years or less.[2,3,4]

Bonds still belong in the big picture. In a bull market, putting money into an investment returning 1.5% for 10 years may seem nonsensical. It may make more sense in light of the goal of portfolio diversification and the need for consistent returns.[3,4]

If interest rates rise continually during the next few years, current owners of long-term bonds might find themselves losing out in terms of their portfolio's potential. On the other hand, bonds have never lost half their value; stocks have.

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Citations.

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