Fixed Income and the Interest Rate Cycle

Fixed income markets are currently at a crossroads, facing the potential for interest rate increases. Short-term yields have been successfully held at low levels for years since the financial crisis. Here at home, the Bank of Canada reduced the trend-setting overnight rate on two separate occasions in 2015 in response to slower economic times due to the low price of oil.

In the U.S., stimulus programs have been wound down as the economic situation has significantly improved. This has been reflected in medium-term yields, driven by investor demand, which have been rising and it is expected (at the time of writing*) that the U.S. Federal Reserve will raise rates in the near term.

Conventional wisdom holds that rising interest rates are bad for fixed income markets because, from a very basic perspective, when rates rise, bond prices fall. But, this simple view may be challenged when considering a diversified fixed income portfolio which may actually perform well during periods of rising rates.

Just twenty years ago, a diversified fixed income portfolio usually meant having a mix of Canadian government and corporate bonds. Fast forward to today where investors now have access to a broader array of fixed income products. The addition of different types of fixed income investments into a portfolio may assist investors to achieve improved returns with marginal changes in volatility.

A 2012 U.S. study looked at different fixed income investments in differing interest rate environments and found that during periods of rising rates, emerging market bonds and high-yield bonds (debt issued by corporations with credit ratings below investment grade) historically performed well.

Saleem Tyab
604-643-7588
E: saleem.tyab@canaccord.com

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Why has this been the case? Interest rates typically rise in a strong or strengthening economy. During these times, investors may be more likely to invest in products that may be considered more risky, such as emerging market bonds or high-yield bonds. For high-yield bonds, as corporate profits improve as a result of an improved economy the financial health and business prospects of the bond issuers can also potentially improve, which may reduce associated risks.

In a rising rate environment, high quality, shorter duration bonds can also help to lower exposure to potential long-term risks because they are less sensitive to movements in interest rates.

**At the time of writing in September 2015, the U.S. Federal Reserve has not yet raised its key interest rate although Janet Yellen has stated that the U.S. central bank remains on track to raise interest rates before the end of the year.*