



2017: Rising Rates and Positive Term Premiums

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Interest rate forecasting has been a favorite pastime of many market participants. As we enter each New Year, for almost the past decade, media articles frequently predict that short-term US government interest rates will rise. This year is no different.¹ A common perception is if such a prediction were to come true, long-term bonds would underperform short-term bonds and fixed income markets would experience negative returns.

Last year provides a simple and clear illustration that even if an investor could have predicted the path of short-term rates in the US, this information would not have been nearly enough to predict the returns of long-term bonds or the bond market.

Short-term interest rates increased by as much as 0.90%² in the US (see Exhibit 1) in 2017. However, short-term government bonds still generated a positive return of 0.45%.³ Interestingly, long-term government bonds returned over 8.5%⁴ in 2017, far outpacing their short-term counterparts. The broad US bond market returned 3.54%,⁵ while the broad global bond market returned 3.04%.⁶

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RISING RATES AND POSITIVE RETURNS

When interest rates increase (for example, US short-term government rates), long-term bonds may still outperform short-term bonds and the broad bond market may still realize positive returns. The reason is that bond returns are driven by more than just changes in interest rates. Among the drivers of a bond's return are its starting yield and expected price appreciation (as its yield decreases through time on an upwardly shaped yield curve—commonly known as “roll down.”) Any losses due to rising interest rates can be offset with starting yield and expected price appreciation.

1. See, for example, Kiplinger's Latest Forecast on Interest Rates.

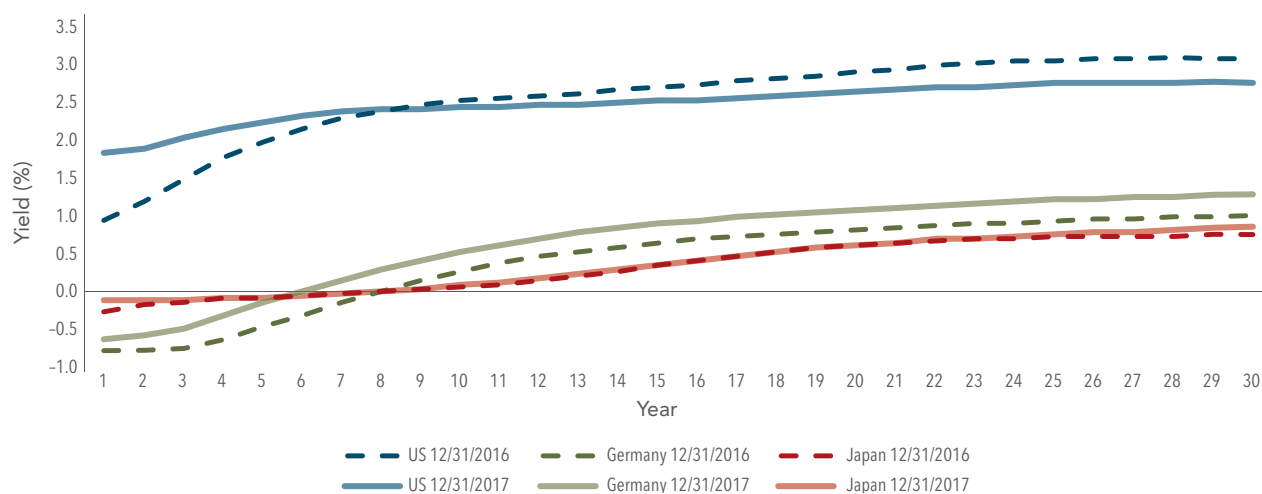
2. www.treasury.gov.

3. As measured by Bloomberg Barclays US Government Bond Index 1–3 Years.

4. As measured by Bloomberg Barclays Long US Government Bond Index.

5. As measured by Bloomberg Barclays US Aggregate Bond Index.

6. As measured by Bloomberg Barclays Global Aggregate Bond Index (hedged to USD).

Exhibit 1: Government Bond Yields (%)

Source: Bank of America/Merrill Lynch government yield. The BofA Merrill Lynch Indices are used with permission; copyright 2017 Merrill Lynch, Pierce, Fenner & Smith Incorporated; all rights reserved. Merrill Lynch, Pierce, Fenner & Smith Incorporated is a wholly owned subsidiary of Bank of America Corporation. Indices are not available for direct investment. Their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

For example, suppose a 5-year government bond yields 2% today, and over the next 12 months the 5-year rate increases by 0.4%. The 2% yield would approximately offset any loss due to the change in rates. If the 5-year rate were to rise more slowly—say it increases by 0.4% over the next 24 months rather than 12—the 2% yield (earned for two years rather than one) would more than offset the loss due to changes in interest rates, and the realized return would be positive.

Adding to this complexity is that changes in yield can be different for bonds of different maturities. One rate may increase while another may remain the same or decrease. In the US in 2017, short-term rates increased while long-term rates decreased, demonstrating that what happens at the short end of the yield curve does not necessarily correspond to what happens at the long end.

Finally, the broad bond market includes many different yield curves and corporate issuers. Their yields and expected price appreciation, and the realization of these components of a bond's return, have generally been very different from those of US short-term government bonds.

LESSONS FROM 2017

All these effects were in play in 2017. While we believe that attempting to predict changes in short-term US

interest rates is a futile exercise, we also believe that using such a prediction to inform the expected return of short-term bonds relative to long-term bonds, or the return of the bond market, is even more futile. Not only do absolute changes in interest rates across many yield curves, maturities, and issuers matter, their starting yields, the starting shapes of yield curves, and the speed at which the changes occur all drive realized returns.

Rather than forecasting interest rates, we can use information in the shapes of current yield curves to position the duration of portfolios to pursue the highest expected returns. Throughout the year, the US and global developed markets yield curves were upwardly sloped, indicating positive expected term premiums, that is, higher expected returns for long-term bonds relative to short-term bonds. Realized term premiums were indeed positive in the US and globally.

Investors who shortened the duration of their fixed income allocation in anticipation of higher interest rates would have missed the term premium in 2017. In fact, if concern over rising rates prompted an investor to have maintained a shorter duration over the past decade, that investor may have missed positive term premiums for most of the period: The broad US government bond market

outperformed short-term government bonds in eight of the past 10 years. Globally, the broad government bond market outperformed short-term government bonds in nine of the past 10 years.⁷

Last year also demonstrated that global yield curves do not move in lockstep. Changes in yield in one market do not guarantee equal changes in yields in other markets. For instance, while the yield curve flattened in the US with rising shorter-term yields and falling longer-term yields, Germany experienced an increase in yields across all maturities, while interest rates were relatively unchanged in Japan (see Exhibit 1). Thus, an investment approach that takes a global view may offer both diversification and higher expected returns.

SUMMARY

Last year highlights that during periods when the US short-term government rates increase, long-term bonds can outperform short-term bonds and fixed income markets can realize positive returns. We are not implying that this result will occur no matter what path interest rates follow. But it is important to remember that many factors can influence the realized returns of the bond market, and changes in short-term interest rates is just one.

Current security prices reflect the expected return that investors demand to hold different securities. A year like 2017 reinforces the importance of focusing on asset allocation, diversification, and using the information in current security prices to improve the expected return of a portfolio, rather than trying to forecast future interest rates.

7. Bloomberg Barclays US Government Bond Index 1-3 Years, Bloomberg Barclays US Government Bond Index, Citi World Government Bond Index ex US 1-3 Years (hedged to USD), Citi World Government Bond Index ex US (hedged to USD).

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