TD Wealth

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Market Update

Important Topic: BONDS: Why Fear Rising Interest Rates and What To Do?

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There is a lot of discussion surrounding the anticipation of increased interest rates and what that means for our investments. Allow me to explain some of this discussion, the fears and our reaction.

First it is important to understand the fundamental relationship between interest rates and bond prices. They are inversely correlated, meaning that when one goes up the other goes down. This makes sense if you consider the case where one has bought a 3% bond for $100.

If rates go up and everyone can now buy bonds yielding 4%, no one will buy your 3% bond at $100. You will have to offer your bond at a lower price, such as $99 so that the new buyer receives 3% interest plus a 1% increase in price to total 4%. If the bond has two years left to maturity then the price would have be closer to $98.

If rates go down and everyone can now only buy bonds yielding 2%, everyone would love to buy your 3% bond at $100. You can then sell your bond at $101 so that the new buyer receives 3% interest minus a 1% decrease in price to total 2%.

Second, recall that markets price in anticipated changes. If the world believes rates are going up, bond prices will fall now to reflect this.

Combining these two points one can understand why bond prices are falling, and have fallen 1.8% year-to-date. Interest rates have increased and the expectation is that they increase further (certainly in the U.S. and likely in Canada) as the economy remains strong and rates will likely be raised to slow down economic activity to fight inflation

The fear is that this continues. If so, one would earn interest but have the price of the bond fall as much, or more, providing no net return over the short term.

This has been a concern of ours for the past three years and we have reacted by diversifying our bond allocation in a number of ways. Here are a few:

- First, we have introduced floating rate bonds. These bonds do not have a fixed interest rate but pay an amount that fluctuates with interest rates. Therefore as rates rise we will be paid more. The price of such a bond fluctuates much less as the interest paid increases to match market rates. Also our Canadian bond manager has moved a large portion of the investments into this type of investment in anticipation of rising rates.
- Second, we have added to our Commercial Mortgage position. These mortgages are all short term and backed by significant and solid assets. While the prices will fluctuate over the short term we expect that all will mature at $100 meaning that all capital lost over the short term will be recouped within a couple of years.

- Third, we have introduced a Global bond allocation allowing the bond manager to select what they believe to be the best opportunities around the globe. There are many countries where interest rates are not rising.
- Fourth, we have introduced or added Convertible bonds. These bonds pay attractive rates and include an option to convert into the stock of the company. If the economy improves interest rates should rise but so should the stock price.
- Fifth, we have recommended moving a portion of the bond portfolio into "Income" producing or "Alternative" investments that are not tied to interest rates.

Market Update: An interesting month

April saw most markets reverse directions. Those that were down over the first quarter were up and vice versa. Only the bond markets continued to fall.

The continued fall of the bond markets in anticipation of increased interest rates poses the challenge described above. We are comfortable that the moves we have made have properly positioned us.

On the equity side, the fundamentals – sales, earnings, and cash flows – remain strong. Earnings in the U.S. were impressive with many companies exceeding expectations.

Prices, however, are at the high end (by many measures), and even with the recent downturn they remain above their long term averages. Remembering that market prices are an attempt to quantify the future success of a company, the above average prices indicate that strong forecasts remain.

Importantly, many companies reported the expectation of continued strong earnings and saw their stock prices rise. However those companies reporting disappointing earnings or disappointing forecasts are seeing their share prices fall, sometimes by 5-10%, quickly. This separation between the successful and the challenged should continue for the foreseeable future. Due to this and the overall high valuation levels, we prefer to avoid the Indices (inexpensive exposure to an entire market) and prefer investing with active managers who are very selective. This is still a time to carefully distinguish between under and overvalued investments.

We remain invested, and looking forward, we remain optimistic for the long term but cautious for the short and medium term. It is time to focus on the long-term. It is time to focus on the plan and the reasons for investing as we do. It is time to consider the specific investments and ensure that the reward for risk-taken is tilted clearly in our favour.

For the Month:

The bond market was down 0.6%, the Preferred market was down 0.8%, the Canadian market was up 1.8%, the US market was up 0.4%, International markets were up 1.6%, the Emerging markets were down 2.9% and the Real Estate market was up 1.8% (Source: Reuters).

Have a great month and let us know if there is anything we can do for you,

Meir