BULL & BEAR BULLETIN

Volume 9, Issue 7

November 2018

Cultivating relationships for over 30 Years Since 1984

VALICENTI ADVISORY SERVICES, INC.

400 East Water Street
Elmira, NY 14901
607-734-2665
Fax: 607-734-6845

447 East Water Street
Elmira, NY 14901
607-733-9022
Fax: 607-734-6157

24 West Market Street
Corning, NY 14830
607-936-1203
Fax: 607-936-0213

www.valicenti.com

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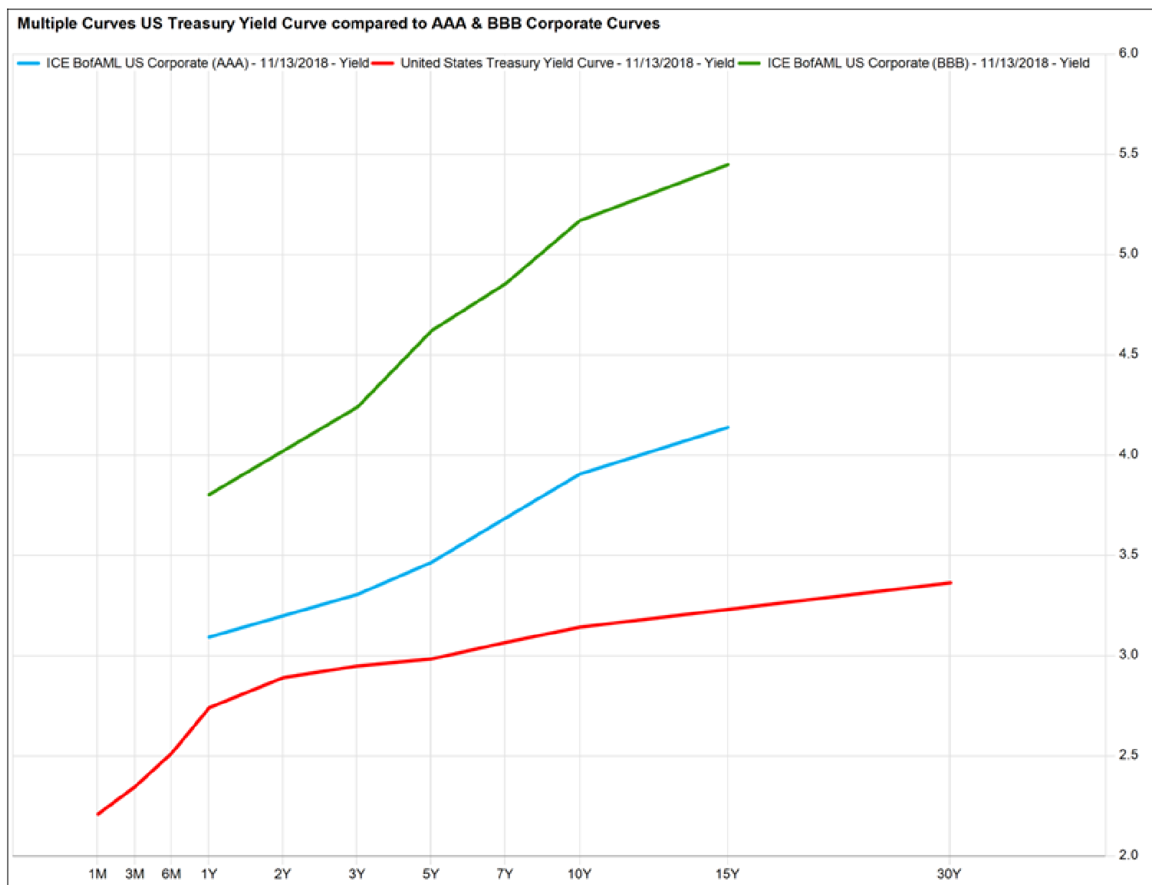
An on-line publication by The Investment Committee

Going Up And Down?

You have heard it in the financial press and have seen it in your own portfolio. “Rates are rising!” You can get more return on your bonds now than in recent years and savers are being rewarded. For some reason though, your bonds are underperforming or even have a negative return for the year. What is going on?

First, what is a bond? A bond is a loan made to some entity (corporation, federal government, municipality, etc.) that must pay interest on a periodic basis, which is usually a fixed annual amount. At maturity, the borrower must additionally return the amount borrowed called principal. The interest rate that the entity must pay is multifaceted but can depend on things such as time/years to maturity, risk of default and the risk-free rate. The riskier a bond is, meaning a longer maturity or higher chance of default, the more investors demand in return for lending money. Additionally, the risk-free rate, the rate at which the federal government borrows money, plays a pivotal role in determining the rate that other entities must pay. Interbank overnight lending, borrowing over a very short time period, is set by the Federal Reserve (FED), while longer rates such as the 10-year and 30-year Treasury rates are determined by the open market. All other entities must borrow at a risk-free rate, plus an additional amount called spread, to incentivize investors for the risk assumed. Finally, these spreads and risk-free rates are in constant flux as investors buy and sell bonds, which is why you see changes in bond prices.

Displayed below is the current yield curve, which shows a snapshot of what entities would pay to borrow. As you move right, the rates increase as years to maturity increase, and as the chance of default increases (the stacked lines), rates increase as well. This gap above the red line is the credit spread.



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So why are your current bonds potentially not performing well? This price movement has to do with the open market described above. For example, you bought a $10,000 corporate bond last year that pays 3% or $300 annually. Now, a year later, the market is demanding 4% for comparable bonds due to rising risk free interest rates. Other investors will not pay you the same amount that you paid, since prevailing rates are now 4%, but you could perhaps sell the bond for $9,600. That is why when interest rates go up, via larger spreads or higher risk free rates, bond prices go down. This results in a -1% loss for the year (+$300 Interest, -$400 Price). Importantly though, if you hold the bond and the company does not default, you will recoup the $10,000 (par) at maturity, unlike equities where there is no assurance that you will recoup what you invested. The loss generated in year one is merely on paper, unless you decide to sell the bond.

Will rates continue to rise? This is on the minds of investors and businesses because rates are real costs of doing business, and no one is certain where the market will go from here. However, the recent rise in rates is predominately from FED policy, GDP growth and inflation expectations. The FED has been raising the interbank overnight rate (Federal Funds Rate) almost mechanically by about .25% every three months since December 2016, when it was near 0%. That means shorter-term borrowing has become more expensive. Longer-term borrowing rates, determined by the open market, have increased as expectations for inflation have increased concurrent with higher GDP prints. Some believe further inflation will come from wage inflation, where employers will have to pay workers more and thus drive up demand/prices for consumer goods, while others believe debt levels, demographics and slowed global growth will keep inflation at bay.

No one has a crystal ball to where rates are headed, but we are at a very interesting point in the economic cycle. Supported by incredibly low rates and FED policy, the economy has been able to regain its footing over the past eight years. With rising rates, companies will have to stand on their own merit, and investors will have to prepare their portfolios based on their outlook. Two approaches for bond investing in rising rates include: laddering and a barbell approach. Laddering simply means having shorter-term bonds with differing maturity dates, so when the bond matures, you can reinvest the proceeds at higher rates. A barbell approach takes this a step further and ladders most bonds in the short-term but also includes longer-term bonds, in case rates do start to fall again. Either way, if rates rise or fall from here, it will be a fascinating time to watch the Bull & Bear fight the good fight in this new chapter of the economy.

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