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Wealth Management

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Investor Insight

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The Changing Bond Market

Investors should be aware of how potential changes in the fixed income landscape may affect their fixed income holdings and prepare themselves accordingly. Two factors can affect the price of bonds: interest rates and inflation.

Since the 2007/08 financial crisis, interest rates have been kept at historically low levels. As economic growth continues, it is expected that interest rates will also rise. In Canada, economic growth has been stalled in the near term, largely due to low oil prices, which has caused the Bank of Canada to hold its key interest rate at a very low level. However, in the U.S., economic recovery has been more progressive and it is likely that the key interest rate will be raised over the near term.

Currently, inflationary threats are not an issue but, with the ongoing deleveraging activities of developed countries, there may also be the possibility of increasing inflation.

Plan to Protect Against Rising Interest Rates

As interest rates rise, bond prices fall. Limiting the number of long-term bonds in your portfolio can help protect against rising interest rates. This is because the inverse relationship between bond prices and yields is amplified as the time to maturity of a bond increases. A longer holding period results in a higher likelihood of the bond being exposed to changing interest rates. By holding bonds with shorter maturities in a rising interest rate environment, bondholders are able to reinvest in securities that provide higher interest rates.

What is Duration?

Duration is one way to assess the amount of interest risk inherent in a bond. It takes into consideration a bond's yield, coupon rate, time to maturity and call features. The calculation of duration, expressed in years, is an indication of the price-sensitivity of a bond to changes in interest rates. A bond with a duration of two years will have a price that will rise (or fall) two percent for every one percent decrease (or increase) in interest rates.

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“Two factors can affect the price of bonds: interest rates and inflation”

Inflation Works Against Bonds

Although it is expected that the central banks will try and keep inflation in check, investors should be aware of the potential impact of inflation. Rising inflation rates put pressure on the bond market. Inflation erodes a bond’s future cash flows and if inflation is expected to increase in the future, investors will demand a higher yield to compensate for this.

As interest rates rise, will we experience a repeat of the early 1990s?

Some of us may remember back to 1994 when a substantial rise in bond yields caused a rapid sell off. This was precipitated by a sudden rise in interest rates that resulted in many investors suffering losses on long-maturity bonds that were purchased using borrowed funds. Many highly leveraged individuals and institutions were forced to liquidate or meet margin calls.

The bond market is quite different than it was in 1994. Today, central banks are much more transparent when they change interest rates, so any changes are unlikely without ample notice. Institutional leverage in the bond market is also more tightly controlled than it was in the 1990s, reducing the risk of a widespread sell-off following an interest rate hike.

We Are Here to Help

As always, we are here to assist. As the market dynamics of the fixed income landscape are expected to change, it may be an opportune time to review the bond holdings in your portfolio.

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