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Are rising interest rates a curse or a blessing?

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Keith: Welcome to the Empowered Investor. My name is Keith Matthews and today I'm joined by my co-host Lawrence Greenberg. Lawrence, how are you today?

Lawrence: I'm doing great. Really glad to be back on the podcast. I think today's going to be a wonderful episode. It's a really great topic to cover for our audience.

Keith: A hundred percent. And for those who are not familiar with Lawrence on the podcast, he's now done four or five, but more importantly, he's one of our lead advisors at our firm and associate portfolio manager and does amazing work. Very caring, very diligent, amazing with clients. Lawrence, great to have you in today's episode.

So we're going to be talking about rising interest rates today. And at first glance, rising interest rates from a bondholder's perspective feel like a curse because what happens in your portfolio are decreasing portfolio levels, bond levels. But what we're going to discuss today is, is it a curse or a blessing?

And so in particular, what we're going to review is sort of year-to-date fixed income numbers, what bonds have generated in terms of returns, and where we're at as of now. We'll review scenarios and we're just really focused on a couple of scenarios to distinguish and show our listeners as to whether this is in fact a curse or a blessing. And then finally, we're going to talk about rising interest rates and the effect on investors but also on borrowers because there's two sides to the coin here. But the first part is really going to be a focus on investors, bond investors. So Lawrence, let's talk a little bit about what's happened so far this year.

Lawrence: Yeah. So it's worth mentioning that it's been obviously a challenging time for investors across the board. Especially in Canada, we have very high inflation. Rates are going up, bonds and stocks are down, and we're getting a lot more questions from clients and we're seeing more and more articles and content out there covering bonds specifically, which are now interesting for the first time in quite some time. Usually, bonds are considered a safe haven for investors. They're supposed to shelter you during times of turbulence, and this year this hasn't been the case.

Keith: You're absolutely correct. Going back over all of the market corrections and the moments when equities decrease, usually investors have been able to look at the bond side

of the portfolio and say, at least it held stable or even got a positive return to counterbalance the negative side on the equities. This year has not been the case. So what would average bond holdings be down for diversified fixed income?

Lawrence: So for the broad index of bonds, the Bloomberg Aggregate Index would be down 13 percent as of October. So that's a pretty big move being down double digits in bonds. And on the balanced portfolio side, a 60/40 portfolio as of October would be down minus 12 percent, and as of September, it was down minus 15 percent for a 60/40 portfolio.

Keith: Yeah, so let's divide that into two. The 60/40 has the equity side, it's got the fixed income side. So there's absolutely no relief on fixed income. But that 40 percent on a 60/40 portfolio has that negative 12, 13 percent on the bond side which is dragging it down. So what's really unusual about this year is when you look at a portfolio, subsequently, of course, we know that today portfolios have recovered quite a bit, but bonds maybe not so much. So we've still got some significant headwinds in fixed income, and we've got some on the bond side of a portfolio anywhere from eight to 13 percent negative depending on what kind of bonds you might hold in your portfolio. That's the sticker shock that individuals are dealing with. And as we think about this, why have these negative returns materialized? What's actually happened in the economy right now?

Lawrence: That's the main question, right? So the big reason why bonds have had this rough year is rates being increased quite aggressively. So the Fed in the U.S. and the Bank of Canada in Canada have been quite aggressive in raising rates to fight inflation. And when rates are increased, interest rates are increased, bond prices go down. To be specific, I'm referring to bond yields being increased when I say interest rates, and that's an important distinction.

Keith: Yeah, it is very important. It's not intuitive for many investors, many clients, when they think about bonds and how bond prices react to bond yields. Because often we'll say bond yields are going up, therefore bond prices are going to come down, and vice versa. Lawrence, can you take a moment and explain?

Lawrence: Yeah, absolutely. So it's not necessarily intuitive and it's an extremely important concept. So when an investor holds a bond, we'll call that the old bond. So let's say you have a bond from a year ago, it's yielding 1%. That was the market a year ago. When a new bond is now being issued in this higher rate environment, yielding, let's say, 4%, this old bond will have to reflect this new marketplace, these higher rate environments where investors get more income. So that old bond with the 1 percent yield will have a drop in price to be competitive. So investors will want to buy that bond. And that's why generally speaking, these bond prices will adjust to the rising rates.

Keith: So bond prices are constantly moving according to current conditions.

Lawrence: Exactly.

Keith: All right. Thank you so much for that explanation.

Lawrence: For some context here, in the U.S., rates are up about two and a half times this year alone. And if I'm looking back towards the low in August of 2020, rates are up seven and a half times. This is a massive move and you can see similar things in Canada as well where rates are up 80 percent this year and as of the low of August 2020, up seven and a half times as well. Rates are much, much higher than two years ago.

Keith: You're a hundred percent correct. And just to put that in context, I think when you speak seven and a half times, the data that you're looking at is something like the 10-year U.S. Treasury low August 2020 at 52 basis points, 0.52 of 1%, and then to November 30th, just prior to the recording of this show, 3.7%, 3.71%. So that's the seven and a half times ratio that you're using. That's a massive move.

Lawrence: Oh, and bonds and interest rates that is huge in magnitude, right? So it's important for context here. These are the rates that anchor all the other rates that investors and borrowers may have, bond investors, borrowers, all that.

Keith: So those rising interest rates have in turn led to negative returns in bond portfolios.

Lawrence: Correct.

Keith: And it's been a big negative. So we're going to call that the gut punch. And we're getting some of this terminology from a recent conference that we went to in Santa Monica with some of our investment partners, Dimensional Fund Advisors, listening to Dave Pleka talk about the gut punch that investors are going through right now. That's the, oh, I look at my bond portfolio and I'm down 10%. It doesn't feel good.

Lawrence: Yeah. Clients haven't seen that in some time, and we're seeing more and more activity. We're spending more and more time with clients going over this. You haven't seen these types of moves in 30 years or so as a bond investor. So it's an important time to cover why are we having this gut punch? Why are we here? And that's the rising rates. And how do we look at the future?

Keith: That's a nice, that's a great way to do the segue because what we're going to talk about now is, okay, so we've hit that gut punch. Now what? And what we're about to walk through are some scenarios where we're going to show our listeners, and it was enlightening for us too, to see this exercise, but we're going to show our listeners how that gut punch leads to higher expected returns, which is in place because of higher yields, which then leads to a trade-off, and then there's a catch-up. And then in fact, at one point, the higher returns lead to better long-term returns, which is actually better for investors at large. You've got a nice Formula One analogy here. Let's use that, and then let's get into this scenario here.

Lawrence: I found this analogy and I found it quite apt that for basics here, when rates go up, bond prices go down. But now as a bond investor, you have higher yields. So the analogy is investors should think of the trade-off as a pit stop in a Formula One race. The pit stop immediately causes the driver to fall back. You have to stop. You're behind the group. But

now you have fresh tires to go catch up to the leader, and you have more juice to catch up. And that's the same thing with bonds. Bonds are down now. You've gone through the pit stop, and now you have fresh tires, and you have the momentum now to catch up, hopefully, and to be better off in the long run.

Keith: What a great analogy. As a rugby player, I like the gut punch one too, but I don't have the catch-up that you have in your example. Let's go into—we've got a spreadsheet in front of us. Walk our listeners through what we're looking at right now and then go through these different scenarios. So I'm going to set the scenario up and then you're going to tell us what the results are. So scenario one would be, imagine going back a year and a half ago when your yield on a bond was 1% and your long-term yields are 1%. So you had a bond portfolio, you bought it a year ago, you've got 1 percent as a return and you get that forever. Scenario two is that the rates go up from one to four. We're going to use this as this rising rate environment. So you've experienced in that scenario a gut punch because rates go up and you're going to show us what those numbers look like. In the case we're looking at Lawrence, duration is critical. Bond maturity is critical. We won't mix up for now in today's episode maturity and duration but think of it as the length of your bond holdings. The shorter the length of the bond holdings relative to your investment horizon, the bond holding will represent the break-even point when you spring forward and thereafter get better returns. So what we're going to talk about here, we're going to look at a scenario where bond duration is about five. And we're going to see that the catch-up occurs at the fifth year, and thereafter there's an improvement for scenario two, which is get the gut punch, have the higher returns, and hold on. So Lawrence, go through sort of year by year and then let's try to describe what's happening.

Lawrence: Yeah. So the big takeaway here is with the first scenario, you're in that 1 percent environment, rates don't go up. So you're plugging along, you're getting that 1%. Bonds didn't have that gut punch as we're calling it. Now with scenario two, you get that gut punch in year one, you're down minus 14%.

Keith: Okay. Let's have a $100,000 portfolio here.

Lawrence: Yeah. So that $100,000 for scenario one, without the gut punch, you're at $100,000 in year one. Now, scenario two, you're down to $86,000. So you're down 14 percent right away from the rising rates from one to four percent. Now, if I look down the column and I scroll at the fifth year, both scenarios are now equivalent. So that is the duration of the bonds. You're now even. You've recovered from that gut punch, and both scenarios are equivalent.

Keith: So what ends up happening is scenario one kind of goes up about a thousand dollars a year until the fifth year when you get to a hundred and five thousand dollars as a bondholder on your hundred thousand. Scenario two has a gut punch, takes you to 86, and now the 86 is growing at 4%. It's catching up. It's got the fresh tires.

Lawrence: The fresh tires are kicking in. In five years, you're now back to even. You're at par. And now the big thing is, now you're a longer-term investor. Let's say the investment

horizon is 20 years. Okay. I'm scrolling down the column. And the result is that scenario one, that $100,000 turned into $122,000 in 20 years.

Keith: In 20 years. Okay.

Lawrence: Okay. For this example. Now in scenario two, that $100,000 instantly becomes $86,000 from the rising rates. At five years, you break even. At the very end, you have $190,000. So the difference is 55 percent more wealth 20 years down the road from those rising rates. So you have more return in the long term.

Keith: Wow, that is massive. That is really big. So what would it be at the 10th year, for example? Because sometimes individuals have a hard time thinking out 20 years. But take me to year 10. My scenario one at 1 percent stays flat. What is my bond portfolio worth?

Lawrence: So after 10 years, your scenario one where you have that 1 percent and that no gut punch, you're at $110,000 of wealth from $100,000. Now if I look at scenario two, you have $127,000 of wealth. So you came out on top. You have more wealth 10 years out from those rising rates. And that's a really important takeaway here.

Keith: Yeah. So this is where we're actually starting to see the light a little bit and say that maybe this is actually a blessing. If you're a bondholder, you actually like these higher rates. We need inflation to become tamed and to fall back. But these rising rates are better than if you just had a 1 percent and it just stayed along at the same path. What happens if rates—that's a great example, Lawrence. Thank you for going through that. We have been showing clients these tables in the last couple of weeks and it's been extremely helpful in letting them see beyond the short-term gut punch or Formula One pit stop where you have to pull aside and watch all the other cars pass you. So what about if in two years from now rates go down and they decrease? What are we going to have then? There's a term we're now throwing around. What are we going to have then for investors?

Lawrence: Yeah. So Keith, he used the term sugar rush. And that would allude to rates coming down at some point in the future, bond prices will go up. So the exact opposite of what we've seen this past year may happen. That is a possibility. And bond returns will be juiced up because of that.

Keith: Actually, it's not—I'd like to take credit but it's not me. It's again, that's Dave Pleka from Dimensional. I just thought his terms were so telling and really helped explain what was going on. But the sugar rush, it's akin to you're a bond investor, you got a yield in a portfolio or one specific bond of 3%. Yields decrease. You get a capital gain in your portfolio, and all of a sudden you have a return of 8%. And you go, wow, I love that. I love bonds. And we've had sugar rushes in the past 20 years. We've actually had them since 1981. We've had decreasing interest rate environments, and that's produced all these wonderful bond returns that people have gotten used to these sort of oversized returns. And so now we've got the reverse and this does happen. So this is exactly what we're dealing with this year. So Lawrence, as we think about this, we've just now shared this idea of what appears to be a curse could in fact be viewed as a blessing.

Lawrence: Absolutely.

Keith: Yeah. Let's talk a little bit about this concept of duration and what we think most investors have as durations for bond investors in Canada.

Lawrence: Yeah, so that's an important distinction here is the duration of your bonds will dictate the outcomes. So for context, our client portfolios have a duration of around four years with yields at around five and a half percent. So these bonds are now yielding a lot more than they would have a year or two ago. And these are these fresh tires that we're alluding to, right? So I would say the aggregate indices, like the general bond funds, will have a duration of around seven years. And that seven years becomes the breakeven point that we're alluding to. So you have that gut punch, it takes seven years to recover, and then after which time you're out ahead because of these higher yields.

Keith: Yeah, the bond universe strategies for Canada is in the 7 percent duration zone. I think a lot of private clients, regardless of whether they're with us or other firms or doing it themselves, might be using laddered bonds, laddered GICs, short-term bonds by and large a little bit more often. And that's good news for investors. The last kind of bond I think that should be in private client portfolios are 30-year bonds. And so take this example now where you have a 30-year duration or 20-year duration, your breakeven in the scenario you've just run is 20 to 30 years.

Lawrence: Yes.

Keith: And most people don't have that as a time horizon or don't wish to have that as a time horizon on fixed income anyway.

Lawrence: Yeah. So for context, for a 20 or 25-year bond fund right now, you'd be down 35%. That is a really big gut punch and will take a lot longer to recover for. So those types of bond investors are not experiencing the same thing as we were alluding to earlier where your investment horizon is shorter than your duration.

Keith: Yeah, a hundred percent. Often there's financial strategists that will suggest to investors that now's the time to go buy long bonds. And when those strategists are making those comments, and I don't think that's appropriate for most private clients, that's a very aggressive trading strategy. Or alternatively, somebody says I'm going to hold long bonds but it's better to hold them for risk of deflation, and that's where long bonds do very well. But again, not an obvious financial instrument to hold for most individuals, especially those that are planning for retirement portfolios, building those portfolios.

Lawrence: Absolutely.

Keith: Most of our clients, we have, as you've alluded to, and most Canadians have short-term durations, shorter anywhere from three to seven, and that means their breakevens are coming fairly quick. And so this rising interest rate environment can actually be viewed as quite positive for them.

Lawrence: Which I think is a really important takeaway here. And we're seeing the negatives and there's skepticism and there's worry, but the takeaway here is that this is actually a positive thing for most investors. I think that's a big win.

Keith: Agreed. A hundred percent. So Lawrence, let's move to the next section of this podcast and we're going to spend just a couple of minutes here because our focus, we really want it to be on a bond investor, but again, there's two sides to rising interest rates. There's investors and there's borrowers. Let's spend a moment on this idea of who feels like perhaps a bit more of a winner now and who feels perhaps a bit more under pressure now?

Lawrence: Yeah, there's obviously two sides to this coin. If you are a borrower, your cost of borrowing is now materially higher, right? So a lot of Canadians may have mortgages, those rates will go up, and they'll feel that tightness on their cash flow and their budgets.

Keith: And for many listeners who have been around for a while, they will remember having mortgages in the 1990s or a time where essentially people used to say just buy a GIC or buy a bond because you're going to get eight or nine percent. So the 1990s was a period where interest rates, real interest rates and interest rates over inflation were actually quite high. It was a wonderful time to be an investor but not a great time to be a borrower. In the 1990s, you had great rates of return. If you're an investor, you're happy. If you're a borrower, not so much. The last 10 to 15 years, it's been actually the opposite. If you've been an investor with very low interest rates, you haven't necessarily liked it, but if you've been a borrower, you've loved borrowing from the bank. You've loved borrowing on your line of credit. You've loved borrowing and getting super low mortgages. And then now we're into a different zone again where the pendulum has swung back towards perhaps an investor and not so much a borrower. So these are cycles that—I don't know where the equilibrium point is. Lawrence, any ideas on that?

Lawrence: Yeah. It's extremely hard to predict where rates will go into the future and what's being priced in. If rates go down at some point in the future, that will be great. If they continue to go up, the breakeven will be extended, but you will have higher yields. And over the long term, these things are net positive. So the big thing here and the big takeaway is that bonds are actually a great value right now. They have higher expected returns in the long run. And that investors should not be moving out of bonds now once you've had the gut punch to go into something like cash or GICs, for example.

Keith: Or shorter-term GICs. Correct. 100%. That's a great takeaway, Lawrence. I guess my takeaway would be that, for example, we've been talking for months now that as investors, we have a wonderful opportunity in equity portfolios, fixed income portfolios, balanced portfolios, because expected returns are higher now. So the stock returns were higher, expected returns, and the bond returns were higher with higher yields. This is great news for long-term investors. We have had a rally in the market in the past six weeks. Whether that will have legs, we just don't know. We don't know, we don't predict, but the bottom line is there were higher expected returns and we should welcome that as long-term investors.

Lawrence: Absolutely.

Keith: So with that, Lawrence, thank you so much for jumping in and participating and being involved in today's show. It's a great concept. The gut punch or the sugar rush, I guess, the curse or the blessing. So those are the big concepts in the fixed income world that we covered today.

Lawrence: Yeah. With bonds, there are sometimes some mysticism and some lack of clarity. So I hope for our audience that it made things a little clearer, a clear picture of how to move forward now.

Keith: Thank you so much again, Lawrence. And to our listeners, thank you for listening to today's episode. Have a wonderful week. Take care.

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