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VIEWPOINT

February 2018

Long-term Bond Investors Shouldn't Fear Rate Rises

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It's a commonly held belief that rising interest rates are universally bad for bond investors because when interest rates go up, bond prices fall. Many investors, concerned that interest rates are about to rise meaningfully as central banks look to increase policy rates, are considering adjusting their portfolios. They may be contemplating selling out of bonds now and reinvesting at a later stage when bond yields have risen. However, this might not be a prudent course of action.

Rates in many countries have increased significantly over the past couple of years without delivering a negative return to fixed income investors. The 10-year Australian government bond yield has risen by 1.11% and the 10-year U.S. Treasury yield by 1.55% from their mid-2016 lows.[1] Furthermore, since bond markets tend to be forward-looking, further increases in rates are already priced in (currently, the fed fund futures market is pricing in three further hikes by the U.S. Federal Reserve by the end of 2018).

Only rises in rates above what the market expects are likely to lead to a temporary mark-to-market loss in bonds (based on market pricing as at 21 February 2018). In fact, rising rates actually tend to benefit long-term fixed income investors, with higher income usually offsetting any mark-to-market loss. To demonstrate how this works, we examined the behaviour of bonds under four different scenarios (covering a wide range of potential macro outcomes) to analyse how returns might be affected. Our analysis showed that rising rate environments not only can lead to positive bond returns, but also tend to benefit bond investors in the medium to long term.

The reasons for holding core bonds as part of a well-diversified portfolio – to preserve capital, provide steady income, diversify risk and offer a hedge against equity market downturns – remain as compelling as ever. In our view, investors who overreact to the prospect of rising interest rates may be doing themselves, and their investment portfolios, a disservice.

SCENARIO ANALYSIS: BUSTING THE RISING RATES MYTH

How do rising rates affect bond returns? This depends on a number of factors: the magnitude and timing of the rate rise, the initial level of yields, the shape of the yield curve and specific part of the curve that sells off, and the investor's time horizon.

We examined the returns for Australian bonds and global bonds (100% hedged into Australian dollars) under four different scenarios:

1. A one-off 50 basis point (bp) rate rise (modelled as an instantaneous, parallel upward shift in the yield curve, occurring at the end of the first quarter)
2. A one-off 100 bp rate rise (modelled as an instantaneous, parallel upward shift in the yield curve, occurring at the end of the first quarter)
3. A 25 bp rate rise occurring semi-annually for two years
4. No change to interest rates.

Our analysis assumed that credit spreads were unchanged and that there was no active portfolio management.

Figures 1 and 2 show the results of these four scenarios on Australian and global bond (hedged) returns over a period of five years. Figure 1 shows that for Australian bonds, only the 100 bp instantaneous shock scenario led to a temporary mark-to-market loss, with bonds posting positive returns in all years under all the other scenarios. While the 100 bp one-off rise did lead to the largest negative returns for both Australian and global bonds over the first year due to a reduction in bond prices, it also resulted in higher returns than the no-change scenario from year 2 onwards.

For the scenario where rates rose instantaneously by 50 bps, Australian bonds continued to post positive returns, albeit lower, in year 1 when the rise occurred. Global bonds posted an almost flat return in year 1, but then both posted higher returns than the no-change scenario in all subsequent years.

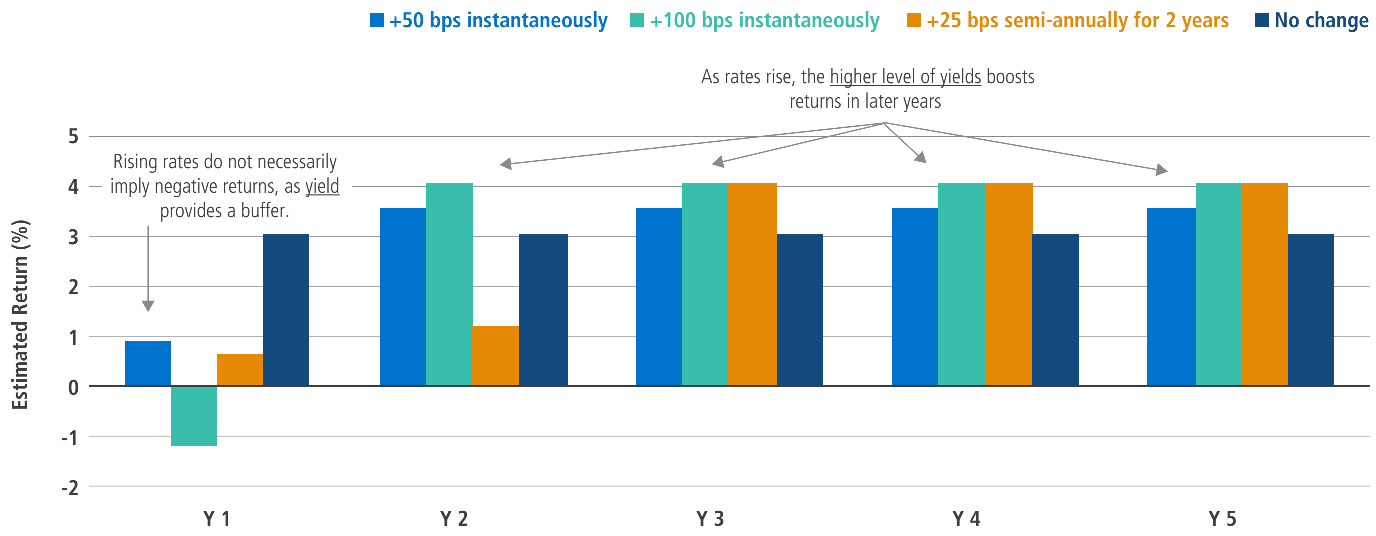
A sudden jump in interest rates is not, in our view, a very realistic scenario. A more likely scenario would be that rates rise gradually over time. This is in line with PIMCO's New Neutral thesis (which we've been discussing for nearly five years now) that central banks will raise rates slowly and to a neutral level that is lower than in previous cycles. This has been the case so far in the current hiking cycle, with the U.S. Federal Reserve and some other central banks raising rates both cautiously and slowly. Considering the scenario where rates rise 25 bps every six months for two years, we see that returns for Australian bonds are low but still positive over the first two years. This is because the yield being earned (primarily from coupons and reinvesting these at higher yields) is enough to offset the temporary mark-to-market losses that result from falling bond prices. After the end of year 2, this scenario results in higher expected returns compared with the scenario where rates remain static.

Global bonds (hedged back into Australian dollars) performed less well under the gradually rising rates scenario, posting a small negative return in year 1 and a lower return than the no-change scenario in year 2. The global index has a longer overall duration than the Australian index and hence suffers a modest temporary mark-to-market loss in year 1. Our analysis assumed an equally large upward parallel shift across all major markets. However, rates across different markets are not perfectly correlated and so in practice there would likely be some diversification benefit as the global index holds exposure across multiple markets. Furthermore, this scenario also resulted in higher returns than the no-change scenario over the final three years of the analysis.

Our analysis assumed the allocation to fixed income remained constant. However, to maintain a constant strategic asset allocation, the overall portfolio would naturally rebalance toward fixed income if bonds posted a negative return (holding all else constant). This would lead to an even higher return (on a dollar-weighted basis) in later years for the rising rates scenarios shown in Figure 1 and 2.

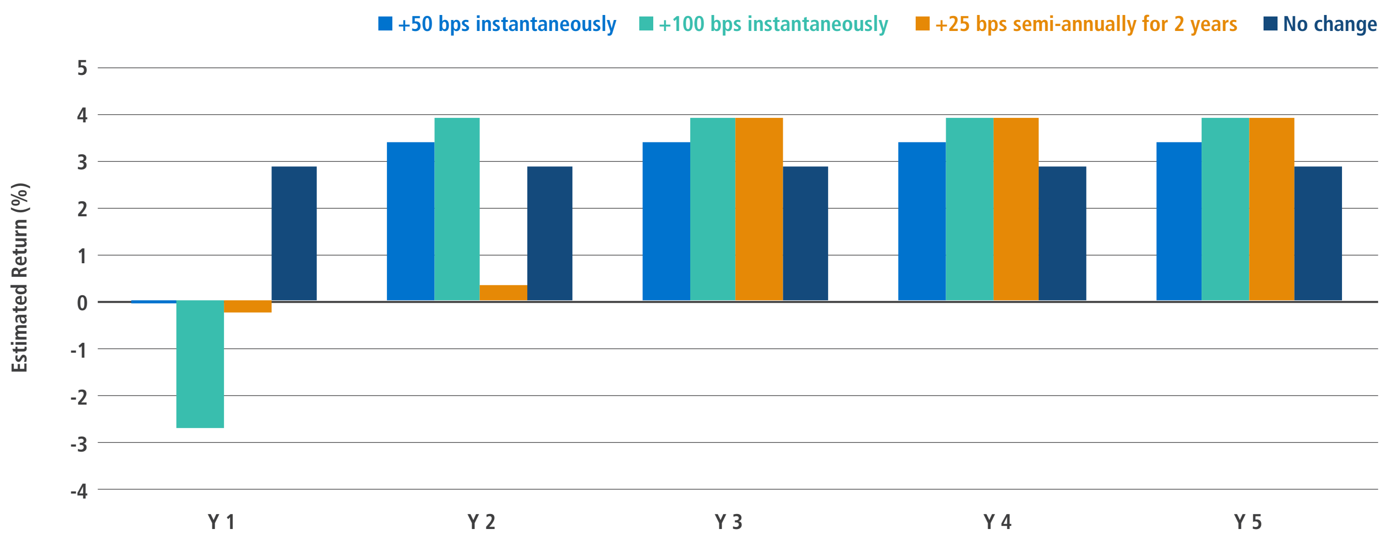
The key takeaways from this analysis are that not only can bond returns be positive during a rising rate environment, but rising rates actually tend to benefit bond investors in the long run.

Figure 1: Period total returns under four scenarios – Australian bonds



Source: Bloomberg data and PIMCO calculations as of 31 January 2018. The Bloomberg AusBond Composite 0+Year Index was used as a proxy for the Australian bond market.

Figure 2: Period total returns under four scenarios – global bonds (100% AUD hedged)



Source: Bloomberg data and PIMCO calculations as of 31 January 2018. The Bloomberg Barclays Global Aggregate Index (100% AUD hedged) was used as a proxy for the global bond market hedged into Australian dollars.

RATES MAY CHANGE, BUT THE ROLE OF BONDS DOESN'T

If bond yields are expected to be higher in the future, investors may ask themselves whether it would be better to move to cash now while rates are rising and then back to bonds later to take advantage of higher yields.

Given perfect foresight, this might make sense. The problem is that timing the market is extremely difficult for even the most experienced investors. If markets are not timed perfectly, the investor typically pays a price since they may well miss out on the yield they would have earned by staying invested.

Regardless of the macroeconomic and market environment, the case for holding bonds remains unchanged and should be viewed in a total portfolio context. A core allocation to fixed income can offer diversification and serve as a hedge against volatility due to the generally low or negative correlation of bonds with other asset classes, particularly in times of economic uncertainty or deflation. As Figure 3 shows, Australian bonds have had a correlation with stocks of significantly less than 1, and often less than zero, over the past 20 years.

As long as there is no default and an investor holds to maturity, bond investments also preserve principal and provide a steady income via their coupon payments. As a result, reducing fixed income exposure may not be ideal in a total portfolio context.

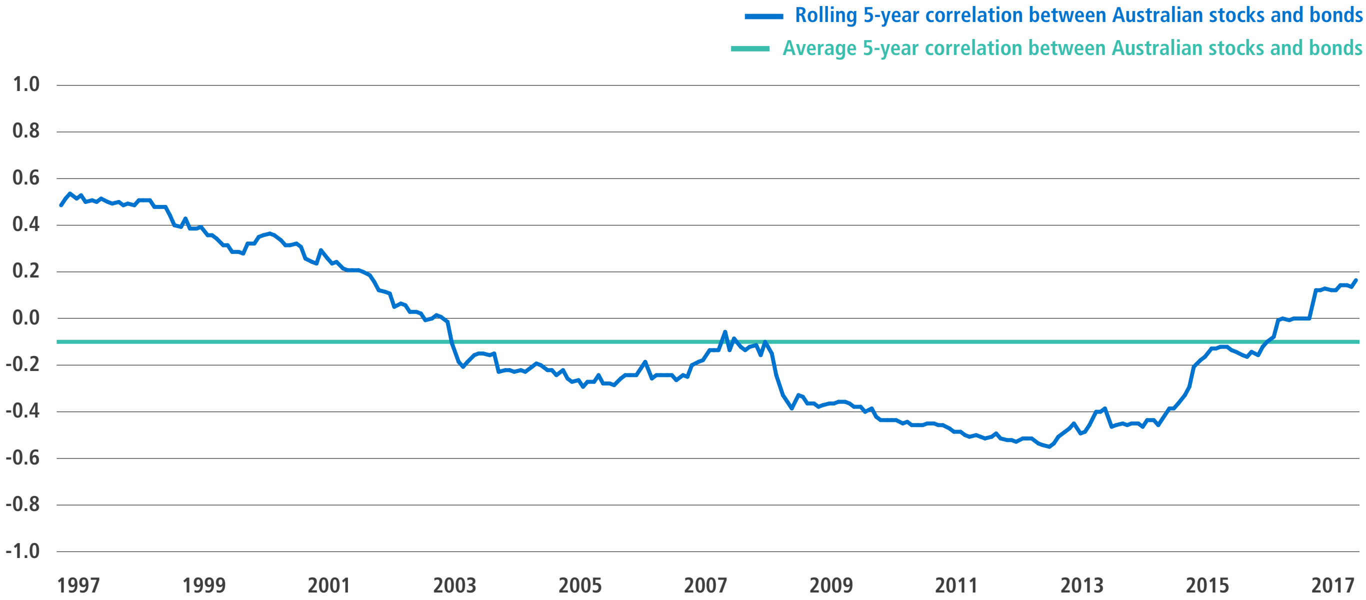
It is also worth noting that over the past 30 years, Australian and global bond market declines have been small and short-lived compared with stock market declines. A fact that might surprise investors is that since 1990, Australian bonds have only experienced negative returns in two calendar years – 1994 and 1999. Despite 1994 seeing a large and disorderly sell-off in the bond market, it posted a negative return of just -4.66%, while 1999 saw a return of -1.22%. Compare this with the three most recent years of negative equity returns (-10.54% in 2011, -38.44% in 2008 and -8.77% in 2002) and it is clear that even in times where bonds do experience losses, they are relatively limited compared with their equity counterparts (see Figure 4).

RISING RATES NOT A CONCERN FOR LONG-TERM BOND INVESTORS

As our scenario analysis demonstrates, rising rates tend to benefit long-term investors, with higher rates ultimately more than offsetting the initial temporary mark-to-market drawdown under most scenarios. For investors considering selling out of bonds and buying back in once yields have risen, it's important to remember that timing the market is difficult and can result in lost yield if not executed with precision.

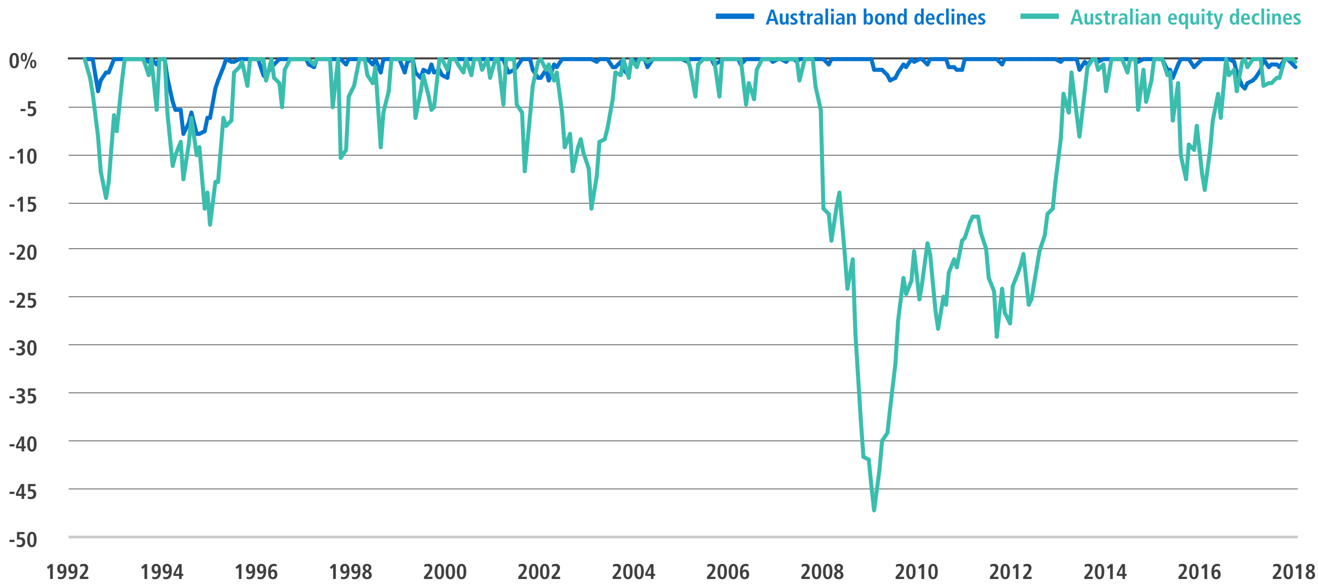
Despite investors' concerns about owning bonds in a rising rate environment, it's important to remember that bonds always have and always will play a key role in a diversified investment portfolio. Active management may also help mitigate some of the risks associated with rising rates. Active managers can spot structural inefficiencies in the market that are created by indexes and other buyers whose objectives create short-term pricing biases and use those as opportunities to identify better priced or higher yielding, quality securities.

Figure 3: Rolling 5-year correlation between Australian stocks and bonds



Source: Bloomberg data as of 31 January 2018. Data represents the correlation between the Bloomberg AusBond Composite 0+Year Index (bonds) and the ASX200 Accumulation Index (stocks).

Figure 4: Drawdowns in Australian bonds and equities



Source: Bloomberg data as of 31 January 2018. Australian bonds are represented by the Bloomberg AusBond Composite 0+Year Index and Australian equities are represented by the ASX200 Accumulation Index.

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[1] For the 10-year Australian yield, this represents the rise from the low point on 2 August 2016 through 15 February 2018. For the 10-year U.S. yield, this represents the rise from the low point on 8 July 2016 through 15 February 2018.

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