IF INTEREST RATES RISE, WHAT HAPPENS TO BONDS?

Investors in longer-term Treasuries could see some rocky road ahead.

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We have seen an epic "flight to safety" this spring. In April alone, $20.6 billion moved into bond funds, according to Lipper. In the same month, $12.7 billion left stock funds (which marked the 12th consecutive month of net withdrawals).[1]

The price of debt has really gone up, particularly U.S. and German sovereign debt. On June 1, the 10-year Treasury yield settled at 1.47% after touching an all-time low of 1.44%. It has consistently been below 2% since April 26. Germany's 10-year notes were yielding around 1.2% during early June.[1,2,3]

The real yield of the 10-year TIPS has been negative since January 24. In fact, it has only finished in positive territory on two days since December 9.[4]

In the short term, few expect the current bond market climate to change. The question is ... what happens when it does?

Are bond investors going to pay for it? At some point, interest rates will rise again; bond market values will fall. When that happens, how many bond owners are going to hang on to their 10-year or 30-year Treasuries until maturity? Who will want a 1.5% or 2.5% return for a decade? Looking at composite bond rates over at Yahoo's Bond Center, even longer-term AAA corporate bonds offered but a 3.5%-5% return in the first part of June.[5]

What do you end up with when you sell a bond before its maturity? The market value; if the federal funds rate rises 3%, a longer-term Treasury might lose as much as a third of its market value as a consequence. It wasn't that long ago – June 12, 2007, to be exact – when the yield on the 10-year note settled up at 5.26%.[2]

This risk aside, what if you want or need to stay in bonds? Some bond market analysts believe now might be a time to exploit short-term bonds with laddered maturity dates. The trade-off in that move is accepting lower interest rates in exchange for a potentially smaller drop in the market value of these securities if rates rise. If you are after higher rates of return from short-duration bonds, you may have to look to bonds that are investment-grade but without AAA or AA ratings.

If you think interest rates will rise in the near future (to the chagrin of many bond investors), exploiting short maturities could position you to get your principal back in the short term. That could give you cash which you could reinvest in response to climbing interest rates. If you really think bond owners are in for some pain in the coming years, you could limit yourself to small positions in bonds.

How exposed are bond funds to EU nations in trouble? According to Morningstar data from early June, global bond funds have an average exposure of 2.1% to Spanish, Greek, Italian and Irish bonds. There are exceptions: in early June, some bond funds had anywhere from 7-11% exposure, believing that the high yields of these bonds are still worth the risk. Some bond fund managers are seeking a short-term advantage by going long on Italian bonds and short on French or German ones, confident that Italy's austerity measures will prove healing.[1]

Appetite for risk may displace anxiety faster than we think. Why would people put their money into an investment offering a 1.5% return for 10 years? In a word, fear. The fear of volatility and a global downturn is so prevalent this spring that many investors are playing "not to lose" - but should interest rates rise sooner than the conventional wisdom suggests, owners of long-term bonds might find themselves losing out in terms of their portfolio's potential.

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Citations.

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