

Strategies for a rising rate environment

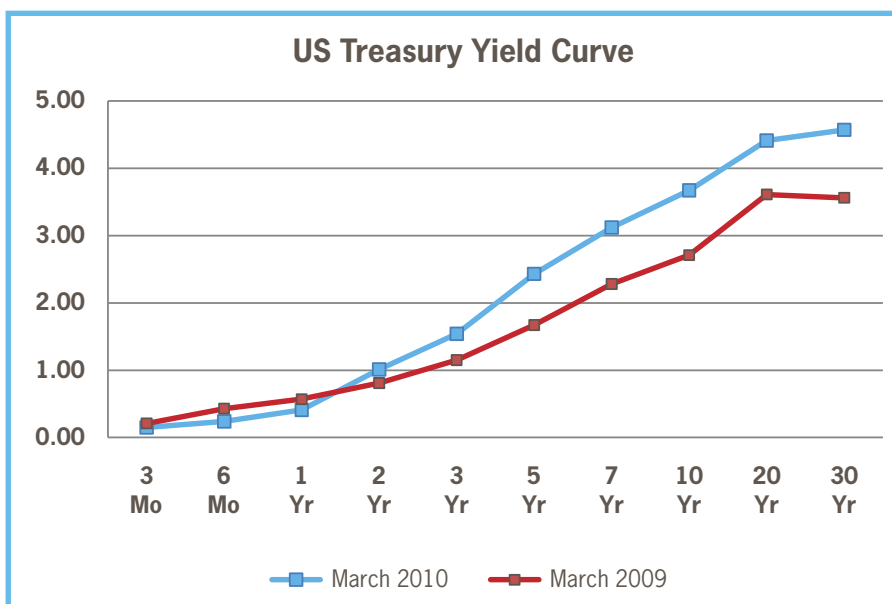
Baker Tilly Investment Advisors, LLC

As the household topic of rising interest rates becomes more prevalent, it is important to consider what strategies you are implementing in your fixed income portfolio. The overwhelming consensus amongst economists is that interest rates will rise in the future. In an effort to stimulate economic growth, the Federal Reserve has put monetary policies in place that effectively lower the overall yield curve. For example, quantitative easing, which targets the longer-dated US Treasury rates, is set to expire shortly.

In accordance with many economists, we feel that the effects of the end of this program may have already been priced into the long-term US Treasury rates. While we appreciate the number of different factors that affect the short end of yield curve, it seems as though the short end of the curve is currently being controlled mainly by the Fed's well-known monetary policy, the Fed Funds Rate. It can be debated as to how an increase in the rate will affect different areas of the curve, with the lingering question being when the economy will be strong enough for the Fed to raise this rate. The yield curve has definitely steepened from twelve months ago, as seen in the year over year comparison chart. But the questions remain:

- > Will intermediate bond rates continue to rise if the Fed raises rates?
- > Has a rate increase already been priced into intermediate and longer dated bonds?
- > How fast will the Fed raise rates once it begins down that path?
- > What magnitude of an effect will a rate rise have on the short end of the curve?

For more information or any questions you might have on this topic, please connect with us at bakertilly.com or 800 362 7301.



Source: US Department of Treasury

While opinions can certainly be made as to the correct answers, there is no evidence that gives us absolute clarity of the best place to be positioned on the curve. However, from a broad perspective, we believe that it is imperative to shy away from long duration bonds. We are finding the short/intermediate areas of the yield curve to be more attractive, with a greater magnitude of principal risk on long duration bonds, and the risk of reinvesting at a lower interest rate having subsided from years past.

A case for short duration bonds

With rising interest rates a probable future event, the case for short duration bonds parallels the fact that as rates rise, bond prices fall. The longer the duration of a bond, the greater the effect a change in interest rates will have on the principal of the bond. Therefore, staying on the shorter end of the curve will mitigate exposure to rising interest rate risk.

For illustration purposes, assume that the effects of rising rates are felt across the short and intermediate term yields at an even rate of a fifty basis point increase as shown in Scenario A. Investors positioned near the short end of the curve would experience a much smaller decline in principal value, making short duration bonds the better performer.

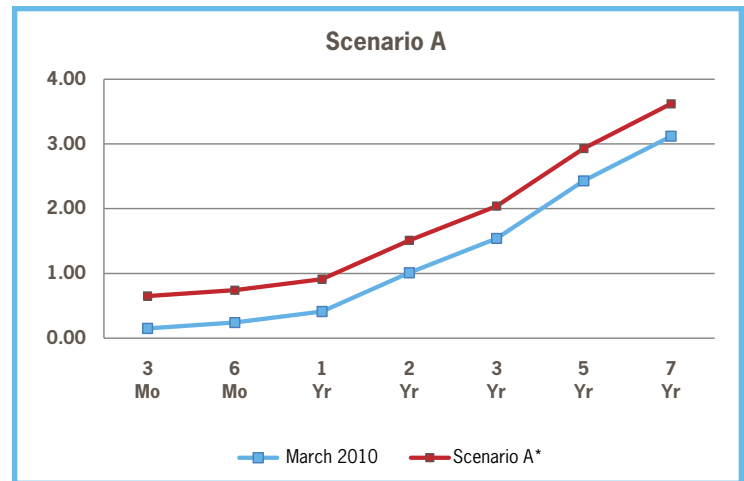
A case for intermediate duration bonds

While we still believe that long duration bonds are risky on a relative basis, there can be a case made for investing in intermediate term bonds versus short-term bonds. As shown in the chart on the preceding page, the yield curve has significantly steepened compared to a year ago with little to no change in the one-year Treasury bill yield, a twenty basis point increase in the two-year note yield, and an eighty-five basis point increase on the seven-year note yield.

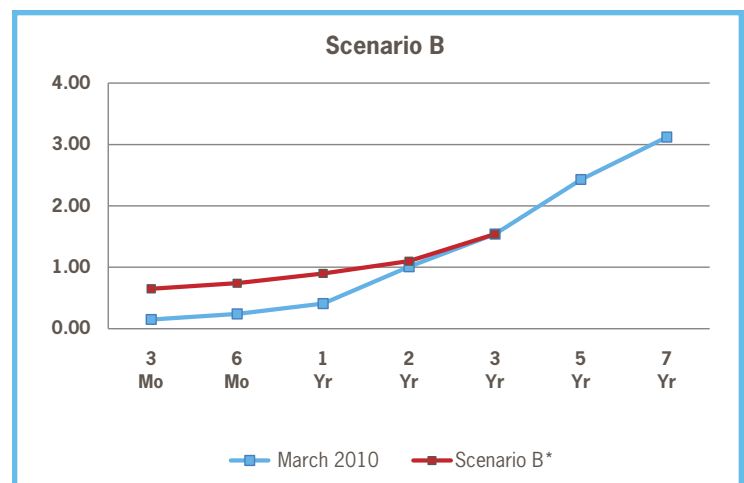
Some investors believe that the two to seven year notes have already priced in a tighter monetary policy. Assuming they are correct and a tighter monetary policy ends up having little effect on intermediate term bonds, we may see a new yield curve that is similar to Scenario B. While this scenario most likely over-simplifies the situation, it does depict the underlying theory that principal loss has already been sustained in intermediate term bonds and they will likely outperform short-term bonds going forward.

While we see merit in both scenarios, we do not feel that it is prudent to make a large bet in either direction. Aside from our belief that long duration bonds are unattractive, we feel that there is a balancing act that needs to be played between short and intermediate term bonds. Given the amount of uncertainty regarding the timing of monetary policy changes and the effects that it will have on the yield curve, it may be beneficial to hedge your fixed income portfolio with short and intermediate term bonds. We encourage you to speak to an Investment Advisor Representative at Baker Tilly to make sure your fixed income portfolio is properly positioned for a rising interest rate environment.

**Scenarios are arbitrarily created for illustration purposes only.*



Source: US Department of Treasury



Source: US Department of Treasury