Business Viewpoint: Bob McCormick analyzes Fed's position on interest rates

By BOB MCCORMICK Business Viewpoint on May 9, 2013, at 1:53 AM *Updated on 5/09/13 at 2:58 PM*

Correction: This story originally contained incorrect information on the impact of interest rates on long-term bonds. The story has been corrected.

At the height of the financial crisis in December 2008, the Federal Reserve committed to lowering interest rates to near zero, and they have been rock-bottom ever since.

The interest rate on many money market funds is effectively zero, and the rate on the 10-year U.S. Treasury note, a key benchmark rate, stands at 1.8 percent. Why do these rates matter to you and me?

First, borrowers - from home buyers to the U.S. government - love low rates, and most of us are borrowers. On the flip side, investors are finding it difficult to earn a decent rate of return with their bonds, certificates of deposit and other fixed-income types of investments. This is especially true when you consider that inflation is eating up most, if not all, of the return.

While most of us are borrowers, we're also investors and, in total, we actually have more money tied up in savings and fixed-income investments than we do in our own debts.

So, with the economy showing modest signs of life, it's a good time for investors to take stock of their bond investments. It's reasonable to expect that when the Fed changes strategy and the economy improves, interest rates will go up. The saver side of us - fixed-income investors - should rejoice if this happens even as the borrower side finds higher rates unappealing.

If interest rates do increase, there are some important facts to remember when it comes to bond investing.

- When interest rates go up, bond prices generally go down. So while investors will eventually be happy earning higher interest, they'll be faced with lower bond prices as rates move up. There are few ways to avoid this drop in value. CDs do not fluctuate in value but most other fixed-income investments do.
- When interest rates move, such as increasing by 1 percent, longer-term bonds will fall in value a lot more than shorter-term bonds. How important is this?

If interest rates rose by 1 percent over the next year, the 30-year U.S. Treasury bond would fall in value by about 17 percent. For that same 1 percent rise, the 10-year Treasury would fall in value by about 8 percent. While both losses are quite large, that is a big difference.

Shorter-term bonds will fall even less. A two-year Treasury would fall about 1 percent in price. Bottom line, if you think rates are going to rise, you want to own shorter-term bonds. However, if rates don't rise, your return on the longer-term bond is going to be higher.

So why are interest rates so low, and what will make them go up? There's no simple answer to either of these questions, but the Fed plays the biggest role in each.

The Fed has taken unprecedented actions over the past four years to keep interest rates low. It is aggressively purchasing U.S. Treasury and mortgage-backed bonds in the hopes of goosing the economy, particularly the housing sector. Once the Fed decides to alter course and lets rates go higher, that rise could initially be rapid.

As mentioned earlier, the current 10-year Treasury rate is 1.8 percent. Two years ago, the rate was just over 3.3 percent. A rise back to that level will ultimately bring a smile to the faces of bond investors, but it could be painful getting there for some.

Ultimately, rates will move up again. But when and by how much? No one, not even the Fed, knows.

Regardless, investors should understand how their bond investments will react in such an environment. Many investors consider bonds to be stable, low-risk investments. The return path to "normal" (higher) interest rates may cause investors to question this assumption, especially for longer-term bonds.

Bob McCormick is senior executive vice president and chief operating officer of Trust Company of Oklahoma, the largest and oldest independent trust company in the state. It manages $3 billion in assets for its clients.

FINANCE

Investing: Earn as much as 4 percent on your money
If you buy a Treasury bond, you know you'll get back your principal.

Insider overview: Devon Energy Corp.
This roundup of insider trading activity is written from information provided by Thomson Financial, a registered investment adviser in Boston.

BUSINESS FEED

Latest Popular Comment

Mike Simons: A journalist becomes a little biased As a journalist it isn't our job to root for outcomes or people. I am making an exception for Truman ...
Mike Simons Staff Photographer
5 hours ago

Oil falls to near $95 as dollar strengthens The price of oil fell to near $95 a barrel on Monday, reflecting the recent strengthening of the dollar ...
PABLO GORONDI Associated Press
7 hours ago

Investing: Earn as much as 4 percent on your money If you buy a Treasury bond, you know you'll get back your principal.
NELLIE S. HUANG Kiplinger News Service
10 hours ago

Insider overview: Devon Energy Corp. This roundup of insider trading activity is written from information provided by Thomson Financial, a ...
THOMSON FINANCIAL REPORTS
10 hours ago

John Clanton: SEEN- Experiencing 1539 A.D. in Muskogee Costumed

AdPost
View All