Stock Market Review

Is it too early to start thinking of rising interest rates?

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Some readers may find the title of this week's article strange given that most international financial commentators argue that interest rates will remain at the present historically low levels for a few more years. In fact, recent forecasts from international economists indicate that the US Central Bank, i.e. the Federal Reserve, will be the first major central bank to announce a rise in interest rates and this is currently expected to take place during the first quarter of 2016. Meanwhile, it is thought that the European Central Bank and the Bank of England will increase official interest rates during the final quarter of 2016.

So, if interest rates are expected to remain stable for possibly another three years, should investors start understanding the implications of eventual rate hikes by taking into consideration their individual circumstances or is it still far too early to act accordingly?

A key factor that investors generally must understand is the difference between official interest rates and changes in yields reflecting fluctuating bond prices. Investor behaviour is very often driven by interest rate perceptions with wide-ranging implications on bond markets as well as equity markets.

In fact, developments over recent weeks confirm that market movements occur well before an official change in interest rates. From early May, when there was an improving outlook for the US economy and as a result the Federal Reserve warned that it could consider starting to scale back its bond-buying program, bond prices declined and bond yields rose rapidly. Since the Fed began arguing in favour of the withdrawal of stimulus measures, the yield on 10-year US Treasuries (US Government Bonds) jumped 0.8 percentage points partially reversing the significant decline in yields (higher bond prices) seen over recent years.

Likewise, yields across other financial markets also responded in the same way with the eurozone benchmark, i.e the 10-year German bund, rising to a 14-month high of 1.853 per cent last Monday from the all-time low of 1.126 per cent in July 2012. It may be worth recalling that prior to the start of the global financial crisis in 2008, eurozone yields hovered around the 4.5 per cent level. While it may not be wise to assume that yields will return to such levels in the short term, it is worth comparing current yields to those of a few years ago. A period of "normalisation" will therefore probably take place with yields rising gradually from present historically low levels reflecting less of a distressed situation.

The recent movement in German bunds was also reflected across the local MGS market with the Rizzo Farrugia MGS Index easing by 0.8 per cent from its recent all-time high of 1,025.288 points reached on May 3, 2013. In fact, many MGS prices declined from their recent record levels with declines of up to three percentage points for some of the long-term bonds.

Investors should take note of the implications of recent bond price movements on their portfolios. Although many local investors may view bonds as investments that are normally held to maturity, it may be a concern for some to see wide fluctuations in secondary market bond prices from one period to the next. Longer-term bonds are more volatile than bonds of a short-term maturity and as a result, it is generally advisable for investors to hold a larger percentage of short-term bonds in a rising interest rate environment as opposed to long-term bonds in order to preserve the value of the portfolio.

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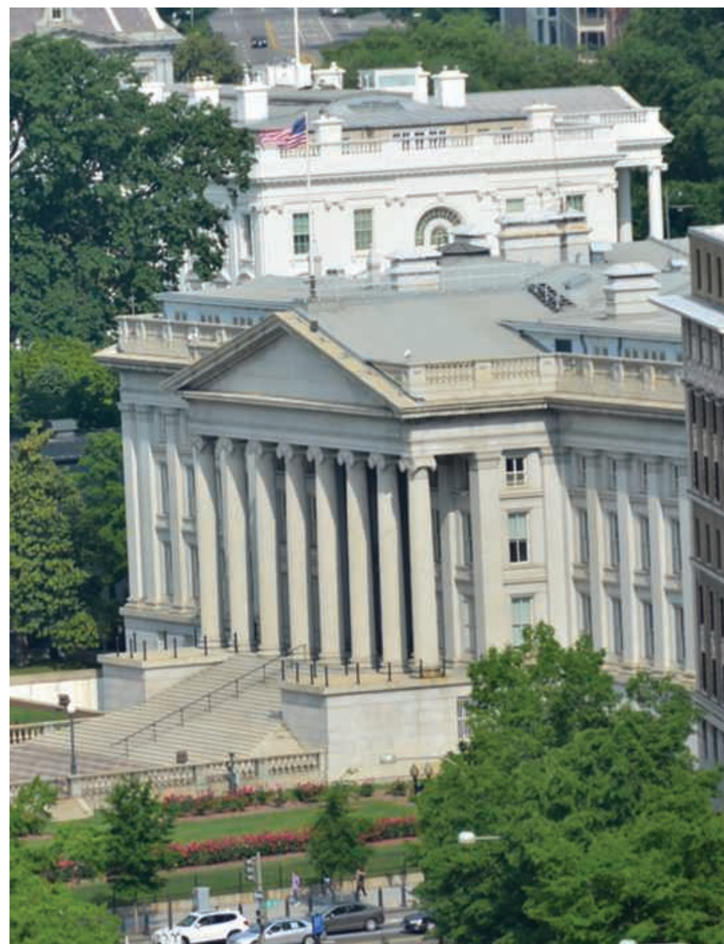
With many investors in recent years possibly exposing themselves to more longer-term bonds than usual in view of the more "attractive" coupon as opposed to short-term bonds, a repositioning of one's investment portfolio may be important in the months ahead since prices of long-term bonds could easily fall below their nominal value during their lifetime. While this may not be a concern for investors who only require the semi-annual interest payments from such bonds, it may become more disturbing for those investors who may require to sell out of such investments before their redemption date.

The recent news that some new local corporate bond issues are likely to be on offer in September and hopefully also in the following months could present a good opportunity for investors to shorten the duration of their overall bond exposures, thereby protecting the value of their portfolios.

Interestingly, many international commentators have also singled out the impact of recent market movements on bond-based funds. International bond funds managed by some of the most-renowned investment houses became very popular with investors over recent years and also in this case, a re-positioning of one's portfolio in view of recent developments ought to be carried out. The *Financial Times* reported some weeks ago that bond funds investing in higher risk assets (such as long-term corporate bonds, high yield and emerging market bonds) experienced significant redemptions between May and June.

A few weeks ago, a high-profile US bond fund manager Bill Gross argued that the great bond bull market of the past 30 years was over. This led to many commentators speculating on the repercussions of this on the overall financial system. While some argued that bond markets could crash and this could be the most serious threat to financial stability, other commentators explained that rather than a full-blown crash, bonds will enter a long bear market since this is what the major central bankers are trying to pursue. The Federal Reserve indicated in the past that it would do its best to avoid a repeat of 1994 when a surprise 25 basis point interest rate hike sent markets into a state of panic.

However, markets always tend to overreact one way or the other so while bond prices may have rallied too high in recent years, it may well be a case that prices will suffer steeper declines than usual. Investors should therefore be prepared for such an eventuality and consider any changes to their portfolio in the light of one's long-term objectives.



Bond prices are falling (yields are rising) principally because the US Federal Reserve has indicated that its strong commitment to creating liquidity in the markets via quantitative easing, i.e. buying huge amounts of bonds in the markets, is coming to an end. This is a result of gradually improving economic developments. It may therefore sound odd that this is also leading to a decline in equity markets. Equity markets were in fact negatively impacted at the prospect of the Federal Reserve actions and declined significantly since the end of May although most international equity markets are still showing positive performances year-to-date. This could be more of a short-term trend and equity markets could resume their upward movement as investors begin to understand that economic fundamentals are gradually improving. Nonetheless, an eventual rise in official interest rates in the years ahead will not help companies with high borrowings due to the higher interest rate burden. On the other hand, it is good news for banks as an improving economy leads to more demand for loans and higher interest charged on such loans.

Rising yields could also impact sentiment towards certain equities that were mainly in demand in recent years due to the relative attractiveness of their dividend yields when compared to bond yields. Such equities could therefore be less in demand in the future depending on the extent of the rise in yields. Some local companies have these characteristics and their high yielding shares have attracted demand in recent years. While their dividend attractiveness may wane in future years if interest rates rise, the present premium between some of the yields on offer compared to returns on Government stocks should not alter their attractiveness in any meaningful way in the years ahead.

Some investors may find it difficult to understand that an improvement in economic data is likely to result in greater volatility and lower values in financial assets especially in the short-term as investors become accustomed to a period of reduced stimulus from central banks. Investors must therefore brace themselves for this changing scenario which has begun well before an official change in the direction of interest rates.

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