Bonds and Interest Rates

What should you do about your bond holdings now that yields are on the rise?

Interest rates on debt have been so low for so long now that we've begun to take them for granted. But as the global economy begins to recover from the shock of COVID-19, there have been stirrings of another scenario—interest rates have been rising in both the U.S. and Canada, and yields in the bond market have risen in lockstep.

Since bond yields and prices tend to move in opposite directions, if you hold bond funds in your portfolio, you've likely seen some negative returns for the first half of 2021.

That's led to some pointed questions from investors. Isn't it reasonable to expect rates to rise since they have been so low? And if they rise further, won't that be a negative for bond holders? Why even hold this asset class if it's just going to lose value?

Check your assumptions

Before you give up on fixed income, you must be 100% sure that rates are indeed going to rise. But predicting the future is a challenge for even the sharpest minds in the market; who, 18 months ago, could have predicted a global pandemic?

Just because yields went up over the past six months, you can't assume they will do so during the next six. Remember that some market watchers have been predicting a bounce-back in bond yields since the 2008 recession; so far, it hasn't happened.

Further, the relationship between rates and bond prices is not as simple as it seems. The impact on bond prices has a lot to do with how fast and how much rates and yields rise.

For this reason, investors should err on the side of caution even when they have a conviction about future trends. While our fixed income team works to add value through incremental interest rate decisions, we always remain prudent and cautious to avoid being overly confident in any one outcome.

Why bonds still matter

Even if we knew for a fact that, 10 years from now, yields would be substantially higher than they are today, there would still be reasons to hold bonds in your portfolio. The first is managing risk. If you hold mostly equities, bonds offer a great counterbalance; when stock markets crash, bond prices usually rise. That may be less important if you have a long investment horizon, but like the markets, you too may face the unexpected—a severe illness or job loss, for example. Then it's important that your nest egg holds its value.

Second, a diversified bond portfolio can be thought of as a conveyor belt that keeps moving forward. As time moves along and bonds reach maturity or receive coupon income, those cash flows are rotated into other bonds. If rates go up, these cash flows that are freed up are cycled into higher-yielding bonds over time.

Third, certain kinds of bonds can actually benefit from rate increases, depending on the cause. If rates are rising because the economy is growing, the spread between yields on corporate versus government bonds often narrows, giving the corporates a bump. Hence, portfolio construction is important: a resilient portfolio will be diversified across sectors and maturities. Again, try not to assume that today's trends will continue into the future.

What should I do now?

It's important to recognize that even as interest rates have risen recently, they are still very low by historical standards. While a rapid increase in bond yields does have the potential to both devalue bond holdings and weigh on economic growth, in the long term, higher rates may reward savers and fixed-income investors, as their current holdings get rolled over into higher-yielding new issues.

A well-diversified portfolio should be able to withstand whatever comes your way. Talk to your financial advisor to find out more about how rates could affect your finances.

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