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Rates are going up - so don't buy fixed interest

Tim Farrelly | farrelly's | 18 June 2014

Everyone knows bond rates are going up - so why would you buy fixed interest? Actually, there are three really good reasons:

- Bond rates may not be going up;
- If they do, they may not go up enough to hurt bond investors; and,
- For long-term investors, rising bond rates are an opportunity cost, not a genuine loss (unless they are driven by rapidly rising inflation.)

Let's look at the first reason not to buy debt - bond rates may not go up. An April 2014 survey of 92 US-based market economists found every single one of them expected the 10-year US Treasury yield to rise over the next six months. Every single one. And what happened next? Long-term rates fell by 0.2% per annum. Most forecasters continue to believe rates have only one way to go in the short term. That should worry them.

But, that is the short term - and farrelly's certainly doesn't profess to have a reliable short-term crystal ball.

What about medium term? Why not defer purchase of five-year term deposits (TDs) for two years to take advantage of the higher rates that will almost certainly be around by then? For this to be a smart strategy, we'd have to beat the 4.6% per annum yield available today on five-year TDs. If we left the funds in cash for two years at, say, 2.5% per annum, then the next three years must yield 6.1% per annum on average just to break even. This is 1.9% per annum higher than current three-year TDs rates. Any less than a 1.9% per annum hike in TD rates and investing in the five-year maturity is the better result, despite rising interest rates. The steep yield curve penalises those who wait. Interest rates need to go up a lot to offset a steeply rising curve.

If, instead of cash, we opted for a two-year TD at 4.1% per annum, the rate on three-year TDs would be required to rise from 4.1% to 5.0% per annum before the deferral strategy breaks even. This is quite possible.

But, even if you believe rates will probably rise by more than that, there is still one more thing to worry about. What if rates fall, a lot?

Falling rates don't normally keep fixed interest investors awake at night, but they should. Compare the risks of the two strategies for conservative investors with substantial secure debt holdings. Say that five-year TDs at 4.6% per annum are enough to pay the bills. If we go to cash and rates fall substantially (as has happened in the US, Japan, UK and Europe) the bills don't get paid - disaster! It's better to lock in 4.6% per annum and, even if rates rise substantially, the bills still get paid. Investors may not be happy having missed an opportunity, but there is food in the house. From a lifestyle perspective, the risks are quite asymetric. Being grumpy is not nearly as bad as being both hungry and really, really grumpy. The long maturity is the safer choice.

Don't buy fixed interest because rates are going up? It's nuts and you can clearly see it's nuts!

Tim Farrelly is principal of specialist asset allocation research house, farrelly's Investment Strategy, available exclusively through PortfolioConstruction Forum. Tim is a member of PortfolioConstruction Forum's core faculty of leading investment professionals.

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