



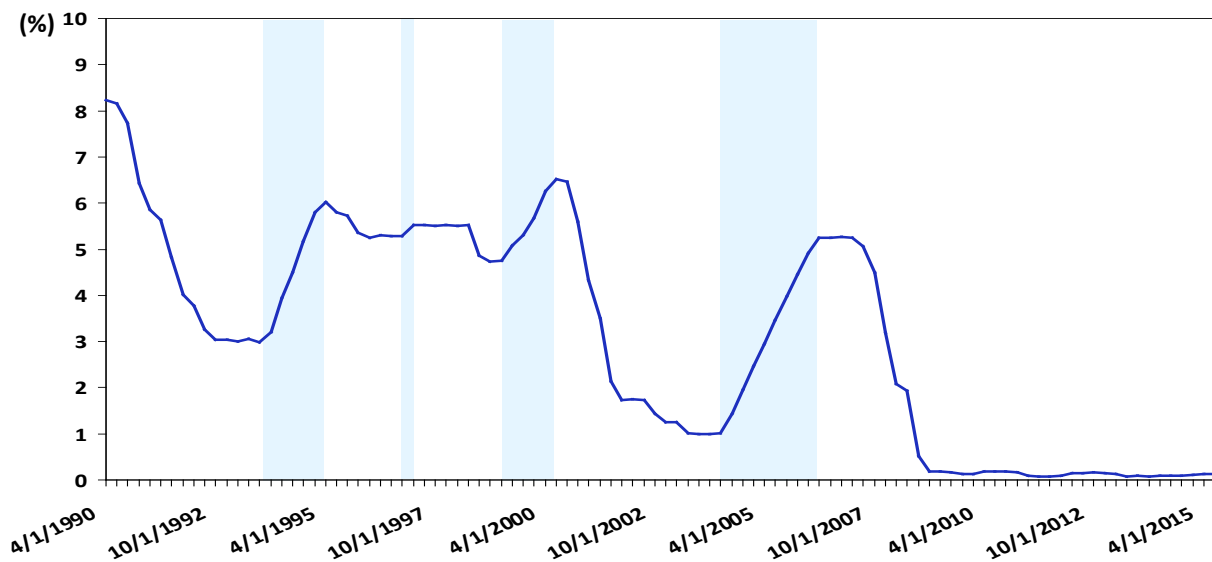
## McDonnell Investment Management Perspectives on the Rising Rate Market Conundrum

September 23, 2015

There is no question that rising interest rates adversely affect the prices of existing bonds. As market interest rates rise, the value of bonds typically declines. That is because lower prices translate into a lower investment, so the fixed coupon rate a bond pays generates a higher yield-to-maturity. Over time, however, higher yields have a counter effect. Cash flows from coupons can be reinvested at higher yields, potentially offsetting the decline in principal.

Because the latter effect occurs over longer periods of time, it is rarely discussed, and many investors continue to focus on the negative price effects of rising interest rates. There have been four periods since 1990 when the Federal Reserve raised the target for the Fed Funds rate. We studied them and, while history is unlikely to repeat, the situations are indicative of how the markets might respond when the Federal Reserve begins to reduce economic stimulus. The two tables that follow detail the Fed Funds rate historical tightenings and the impact on taxable bonds, municipal bonds and municipal cash equivalents.

### Fed Funds Rate Tightening Cycles



Blue shading denotes periods of Fed rate tightening. Source: Federal Reserve Bank of St. Louis. Data through 6/30/15.

We measured returns on taxable and municipal bonds through each tightening cycle by comparing the returns of the Barclays U.S. Aggregate Bond Index, Barclays 5-Year Municipal Bond Index and the Barclays 10-Year Municipal Bond Index to the municipal cash equivalent index published by SIFMA (Securities Industry and Financial Markets Association). For the purpose of the study, we compared returns from the start of the first quarter when the Fed began tightening through the first quarter after tightening ended.

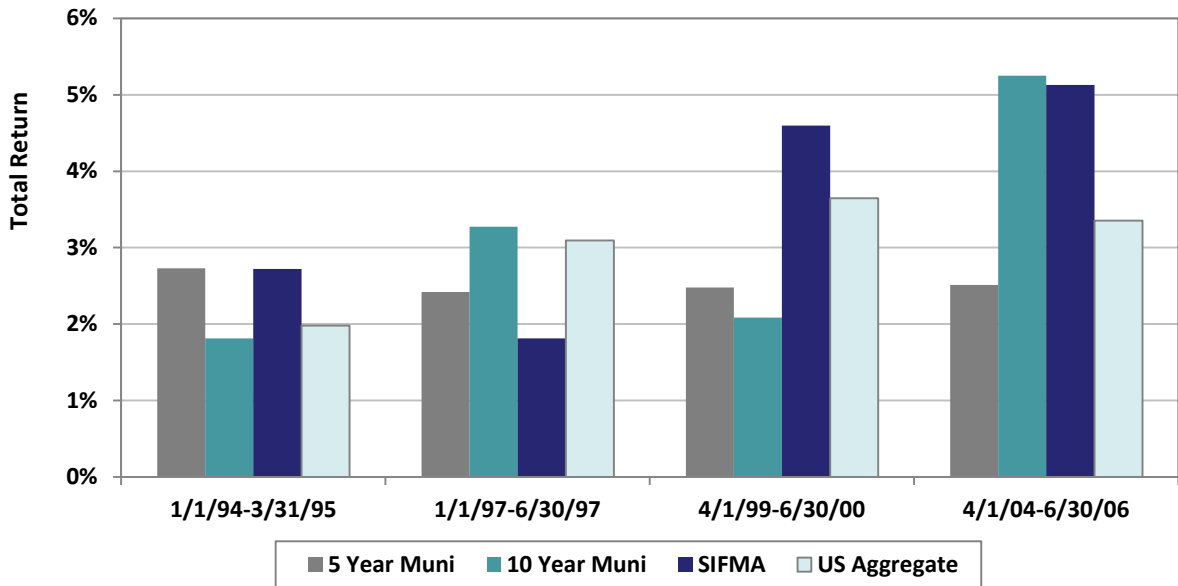


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- In none of these periods did the bond indices register a negative total return.
- The lowest total return through the tightening cycle occurred in 1994 when the Barclays 10-Year Municipal Bond Index registered a 1.81% return and the Barclays U.S. Aggregate Bond Index experienced a 1.98% return.



The return data for the Barclays Indices were analyzed based on the time period of 1/1/94 through 6/30/06. The Indices are unmanaged and include the reinvestments of dividends/interest and other earnings and do not reflect any fees or expenses. McDonnell Investment Management believes the data to be reliable but does not make any representations as to its accuracy or completeness. It is not possible to invest directly in the Index. Past performance is no guarantee of future results. Sources: Barclays; SIFMA; McDonnell Investments Data.

### ➤ Notable Market Highlights

**The Worst Bond Market** – The most devastating year on record for bonds remains 1994. Bond prices were impacted by the magnitude of the interest rate move and relatively short time frame. For the calendar year, the Barclays 10-Year Municipal Bond Index declined -2.74% and the Barclays U.S. Aggregate Bond Index declined -2.96%. The Fed engineered an aggressive tightening schedule, raising the Fed Funds rate from 3% to 6%.

**One and Done** – In March 1997, the Fed sought to initiate a preemptive strike against inflation. After an initial rate increase of 25 basis points, rates were held unchanged for two years due to international events, including the Asian Contagion Crisis and the Russian default. This example may be illustrative of expectations if the initial move by the Fed is followed by an economic slowdown, deflation or an international crisis.

**Tech Bubble** – Concerns that the economy was approaching full employment, which would exacerbate wage pressures leading to inflation, caused the Fed to initiate a series of rate increases which slowed the economy and spurred the end of the tech bubble in 2000. One year after the rate increase, bonds remained in positive territory; however, equities declined 11%.



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**Slow and Steady** – The most recent rate increases occurred in 2004 through 2006. The slow increase was characterized by regular communication from the Fed. In contrast to 1994, rate increases were extended over two years. Both bond and stock markets gradually adjusted to the news. The housing industry, though, was seriously affected due to excessive leverage in the system. This period ended with the largest economic decline since the Great Depression. To help the economy recover from the “Great Recession” the Fed, in coordination with the world’s central banks, embarked on record economic stimulus.

While history rarely repeats, the data suggests that higher interest rates are not as adverse for bond returns as is commonly perceived. Depending on economic activity, which the Fed claims to respond to at each meeting, we believe the next rate increase is more likely to resemble the 2004 to 2006 ‘Slow and Steady’ scenario. Given the unprecedented low interest rates, small rate increases over an even longer time horizon than the 2004-06 period may be necessary. The longer time horizon allows bond investors to benefit from the reinvestment of coupon income, thus potentially mitigating the impact of price declines. However, fears of triggering a recession remain preeminent in the Fed’s mind, so a repeat of the 1997 ‘One and Done’ increase is not out of the question.

Regardless of the course the Fed takes, longer-term bond investors should eventually benefit from higher rates in our view. Although short-term losses may occur, this underscores the importance of a long-term investment time horizon in planning for personal investment goals.

**McDonnell Investment Management – Investment Team**

#### **Notes and Disclosures**

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*Sources: Barclays; stlouisfed.org; The Phases of U.S. Monetary Policy; Marvin Goodfriend; Federal Reserve Bank of Richmond, Economic Quarterly Volume 88.*

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