IdahoTrust

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WealthManagement

SOLUTIONS FOR YOUR LIFENEEDS™

Market Insights

A periodic newsletter from Idaho Trust

With interest rates and bond yields at exceptionally low levels and the economy showing some modest signs of improvement, many investors have been wondering "when will interest rates start to rise?" The prospect of rising rates will have a dramatic effect on their investment portfolios. In particular, bond investors have been questioning what the future holds for their investments in a rising interest rate environment.

Rising Rates' Impact on Bond Values

Bonds and other fixed income instruments are unique because their future cash flows are known, unlike stocks. When an investor buys a bond they know that periodically the bond will make fixed coupon payments and the principal will be repaid at maturity. These features of bonds make them sensitive to current yields or, more specifically, the expectation of future interest rate moves. For example, if an investor purchases a bond and a short time later market yields rise, this change in interest rates will affect the price of the previously purchased bond as newly issued bonds will have higher coupon payments. The bond that the investor purchased will decline in value as the coupon payments (which are typically fixed unless they are adjustable rate bonds) is lower than those on the newly issues bonds. This lower price on the investors previously purchased bond will increase the stated yield on the bond, even though the coupon payment stays the same.

Idaho Trust Bank offers total wealth solutions including its LifeNeeds™ investing process. The LifeNeeds™ investment process utilizes proven strategies and techniques delivered by a highly trained staff of wealth management professionals.

LifeNeeds™ wealth management accounts feature optimized asset allocations, robust security screening and Idaho Trust's unique TacticLogic™ investment process. All of which are tailored to our clients' unique financial needs.

The adjustment in price allows the bond to trade at a yield that is similar to the newly issued bonds. This is a simple example of the inverse relationship that bond prices share with interest rates. When yields rise, bond prices decline and vice versa. Bond investors fear rising market yields will negatively affect the performance of their current fixed income holdings. Generally speaking, market yields are at or near historically low levels and have been for some time thus leaving investors preparing for a time when the economy is strong enough to cause upward pressure on interest rates and market yields.

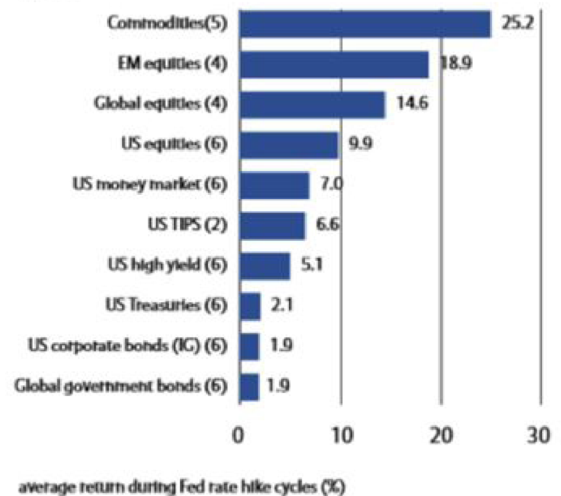
Bond yields offer depend largely on the characteristics of the bonds themselves. Typically, bonds with longer maturities or lower credit ratings will offer higher yields to entice investors to invest in them. When graphed, these yields create a yield curve, which generally slopes upward as bond maturities get longer. The level of yields on the short-end of the yield curve are influenced by the rates set by the Federal Reserve Bank. Conversely, the longer-end of the yield curve is more influenced by the market's inflation expectations, among other things. Yield curves change over time adjusting to new market data both in level and in shape. These changes in yield curves impact the performance of bond portfolios.

Because a significant portion of a bond's total return is derived from the income that it provides rather than merely price changes, the prospect of a bond bear market is not nearly as severe as a bear stock market.

Impact of Rising Rates on an Investment Portfolio

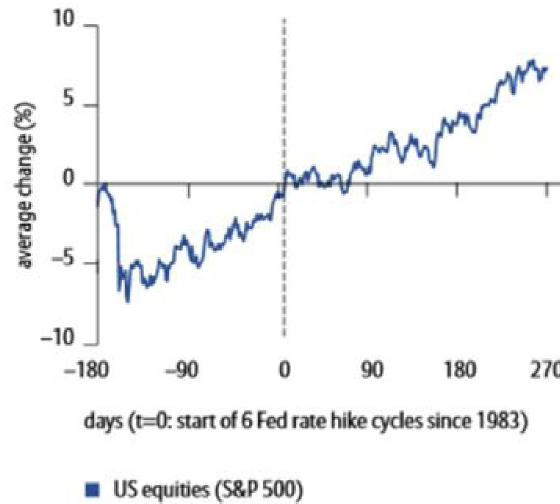
Historically, asset classes have had varying reactions to the Federal Reserve (Fed) raising interest rates. The attached chart provides a summary of what the average return has been during a Fed rate hike cycle. The chart depicts commodities having the strongest performance followed by Emerging Market (EM) equities. Higher inflation rates have been an important reason for the Federal Reserve to raise interest rates. Commodities tend to be a beneficiary of higher inflation as do EM equities since these areas have a higher concentration of commodities

Average return of asset classes during Fed rate hike cycles[1]



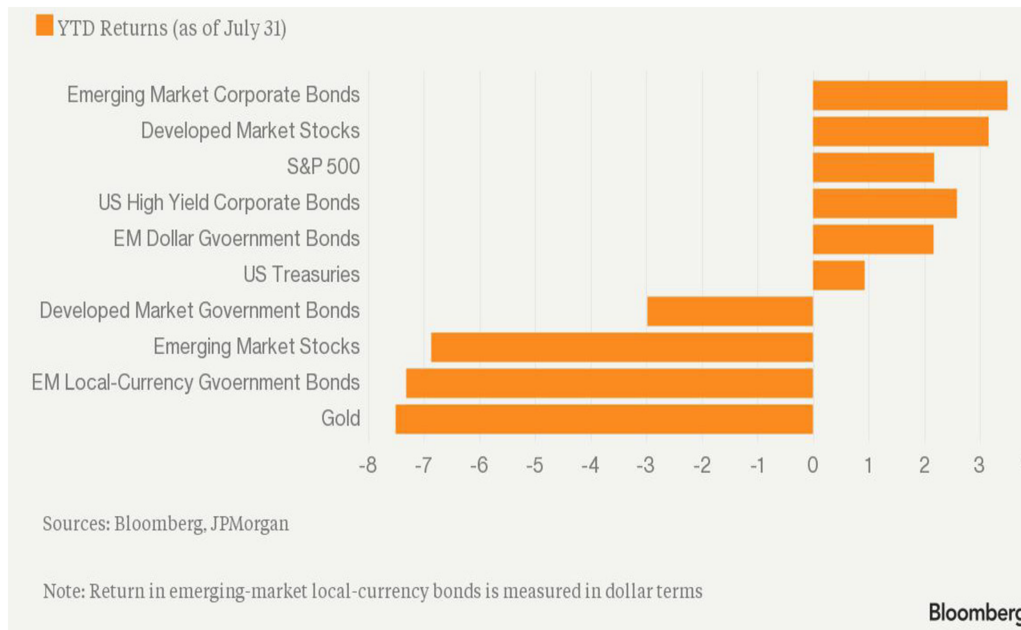
producers. It is important to note that fixed income investments, such as U.S. Treasuries or Corporate bonds have had positive returns, albeit at much lower levels, during the periods of rising interest rates.

The graph on the right shows the average return of U.S. equities before and after the initial rate increase. As you can see, U.S. equities tend to decline by slightly more than 5% in the six months leading up to the initial rate increase. However, U.S. equities generate positive returns following the start of a rate cycle hike, as the Fed tends to lift rates in reaction to a strong economic environment.



Conclusion

Returns on various asset classes may be somewhat different than the past as the Fed is not raising interest rates in order to slow the economy but rather trying to normalize interest rates following the period of extraordinarily accommodative monetary policy following the credit crisis.



S&P 500 Index

3 Month	1.41%
Year-to-Date	3.35%
1 Year	11.20%
3 Year	17.57%
5 Year	16.22%

MSCI EAFE Net Index

3 Month	-1.32%
Year-to-Date	7.72%
1 Year	-0.28%
3 Year	12.32%
5 Year	8.01%

Barclays Aggregate Bond Index

3 Month	-0.64%
Year-to-Date	0.59%
1 Year	2.82%
3 Year	1.60%
5 Year	3.27%

As of 7.31.2015

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