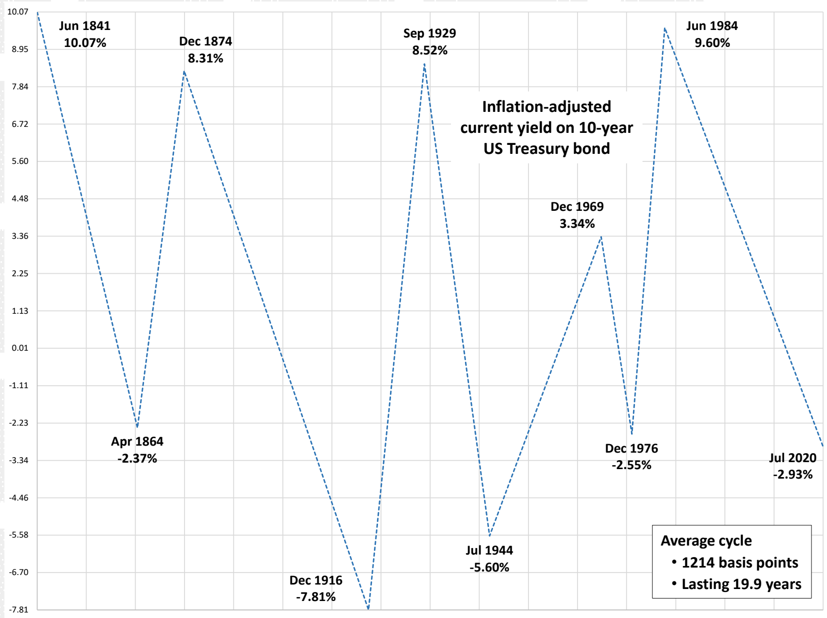
Integrated PARTNERS

Successful Bond Management

Interest rate cycles - Long and large

Interest rates are nothing new. Governments, corporations, and individuals have borrowed money for hundreds, if not thousands of years. We have a deep understanding of interest rate behavior. This history tells us everything we need to know about how interest rates are likely to proceed into the future.

In brief, interest rates follow cycles. Historically, these cycles have been quite large and long lasting. They're pretty big deals, serving to change everything around us, for better or worse, most often a little of both.



The average interest rate cycle (either up or down) lasts 19.9 years and moves interest rates by 12.14%. The graph at the right shows the history of interest rates (for a 10-year US Treasury bond). The numbers shown are after inflation has been subtracted out. Adjusting for inflation is absolutely necessary. Why? For two reasons. First, inflation has varied to such an extent (extremely high to extremely low), that without this adjustment, historical interest rates would be nothing more than meaningless noise. Second, investors only care about what they can actually purchase with their money (in other words, after adjusting for inflation).

The current interest rate cycle - When will rates stop rising

Interest rates here in the US bottomed out back in July of 2020 with the inflation-adjusted yield on the 10-year Treasury bond at -2.93% (yes, a negative yield). And they have been rising ever since. Today the inflation-adjusted 10-year yield stands at 0.44%.

So, when will interest rates stop rising, and at what level? This is a pretty important question to both ask and adequately answer. The best possible starting point for an answer would be to assume what is normal, typical, and incredibly boring. In other words, assume the future is no different from what we experienced in the past. Such an approach is conservative and prudent, it relies on no heroic assumptions and no crystal ball predictions of the future.

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And if the future is like the past . . . then as noted above, interest rates (after adjustment for inflation) will rise by 12.14% over a period of 19.9 years. This would be the "*middle of the fairway*" outcome. And would result in interest rates peaking in June 2040 at 9.21%. Is this what will happen? Of course not! But it does represent the normal, typical, garden variety outcome. And in that sense, provides an incredibly realistic expression of what could unfold. There probably exists a 50/50 chance that the current cycle could be on either side of this outcome, offering something milder or more severe.

Also keep in mind that the current cycle of ever rising interest rates won't follow a straight line. There will be sizable wiggles along the way. For example, interest rates could fall significantly during the next economic recession (as they proceed towards their eventual peak in "*June 2040*").

Why must interest rates continue to rise?

But why must interest rates rise? Nothing ever happens without clear reason. And certainly, interest rates aren't going to rise from -2.93% (July 2020) to 9.21% ("*June 2040*") without some pretty big and darn obvious drivers. I suspect the answer is that we (both the US and the global economy) are executing on a series of seven rather large projects. Projects that are of rare and exceptional size. They're expensive and require down right breathtaking funding. I'm neither agreeing with or disagreeing with any of these. But I do have sufficient common sense to recognize that they are proceeding.

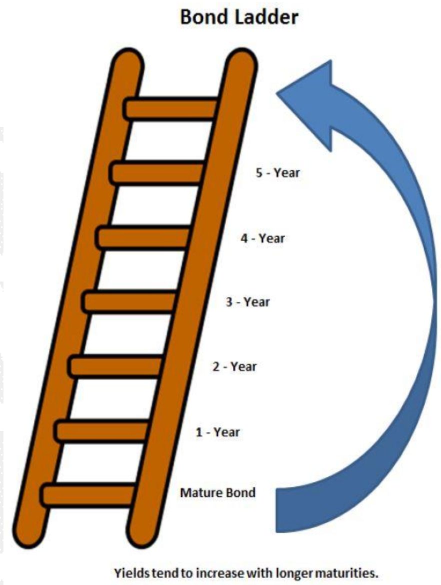
- Cold war with Russia (certainly a hot war for several nations)
- Cold war with China
- Conversion from fossil fuels to renewables
- Shrinking the existing income inequality gap
- Shrinking the existing wealth inequality gap
- Expanding social welfare programs
- Transitioning from one political structure . . . to a different political structure . . . this is costly because of the uncertainty, dislocation, and inefficiencies that it imposes

Collectively, these seven projects place an unprecedent funding requirement on the domestic and global economies, serving to drive interest rates higher . . . not for years, but instead for decades.

Successful bond management during 20 years of rising interest rates

There are several methods for successfully managing a bond portfolio during 20 years of continuously rising interest rates. But one of the most straightforward, reliable, and easiest to execute is that of the Buy & Hold bond ladder. The key components of such an approach include:

- Structure the portfolio as a bond ladder



- Bonds are purchased and then held until maturity
- This is best accomplished using Bond Term Funds (BTFs)

By following this approach, we anticipate or expect the following benefits:

- The investor will earn a net profit (with near 100% probability)
- This net profit will be equal to the current yield of the BTFs when they are first purchased for the investment account (less, fees, expenses, and unanticipated defaults resulting from an unusually severe recession)
- The only practical way that the investor could not earn a positive return is if one or both of the following held true:
    - The investor liquidated all or a major portion of the account prior to the maturity dates on the bonds
    - We experience an extremely severe recession, e.g., something worse than The Great Recession

Bottom line

Yes, our expectation is that the general level of interest rates will rise for another 15-25 years. We'd be shocked if such a rise were straight line. Instead, there will likely be ups and downs, particularly during the coming recession.

Through most (if not almost all) of this period, interest rates will rise at a gradual pace - measured and slow. As a result, our approach of using a Buy & Hold bond ladder will benefit considerably from a continuously rising interest rate environment.

Your financial advisor has a menu of possible investment solutions that are directly relevant to the dynamics discussed above. But the solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

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The use of a proprietary technique, model, or algorithm does not guarantee any specific or profitable results.

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