

Interest Rates and Your Portfolio

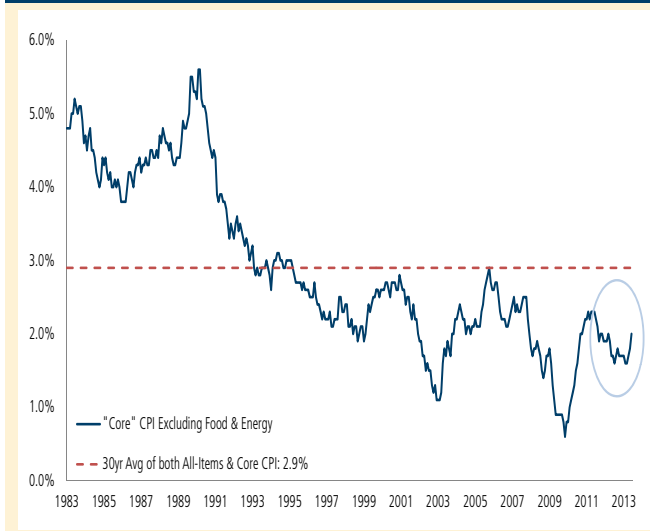
INFLATION

As one of the first parts of our “*What If Interest Rates Rise?*” series, we published a discussion of the potential causes of higher interest rates in the U.S. The list included higher inflation, greater supply of bonds, reduced demand for bonds, and Federal Reserve action. Since that series first debuted, interest rates have risen, with yields on the benchmark 10-year Treasury note going from a low of 1.63% in May 2013 to a high of 3.03% in December 2013, and back down again to about 2.55% today. The main source of those moves in interest rates was the fourth item on our original list of risk factors, Federal Reserve action. But now, halfway through 2014, the Fed has been clear about their policy plans, which leaves three other factors behind potential future moves in interest rates. We’ll focus on one, inflation.

Despite a few headlines about higher milk or gasoline prices, inflation has been generally quite tame. The Consumer Price Index, one popular measure of inflation, has noted an average 2.1% annual inflation rate over the last five years—and that number includes food and energy. Excluding food and energy, the CPI “core” inflation rate averaged 1.7% over that same period—well below its three-decade average. Why exclude food and energy when looking at inflation? In the long run, inflation with and without food and energy is identical (both averaged a 2.8% inflation rate over the last three decades), but in the short term, shocks to oil prices or the food supply caused by wars or droughts can cause price spikes that are just temporary. Inflation isn’t just a bump-up in prices, it’s a persistent year-over-year pace of increases in prices.

Bonds and interest rates are generally impacted by longer-term inflation. How they’re impacted is two-fold. First, inflation reduces the theoretical value of future bond payments. Most bonds promise a series of regular interest payments, followed by a final principal repayment of a fixed amount. For an investor, inflation means that the final principal payment (as well as the interim interest payments) will be able to purchase less in the way of goods

Chart 1: CPI Inflation is Below Average, but Trending Up



(Source: Janney FI Strategy, Bureau of Labor Statistics)

or services. For example, a college education that might cost \$100,000 today will at a 2% inflation rate cost \$143,000, and at a 3% inflation rate cost \$170,000 in 18 years. If an investor with a new child purchases a bond today expecting a 2% inflation rate, but actual inflation is 3%, that bond will come up \$29,000 “short” for the higher college payments.

If Actual Inflation is:	2032 College Expense Will Be:	Your Investment Shortfall Will Be:
2.0%	\$ 142,825	\$0
3.0%	\$ 170,243	\$ (29,074)
4.0%	\$ 202,582	\$ (61,412)

(Source: Janney FI Strategy)

Second, expectations of future inflation will reduce the current market value of bonds and cause interest rates to rise today. In the above example, if the bond markets come to expect that inflation over the next 18 years will rise to 3% (rather than the originally-expected 2%), market participants will demand 1% higher interest rates to compensate for the additional inflation. The result for an investor who already owns our theoretical 18-year bonds will be a decline in market value of the bond approximately equal to that \$29,000 “shortfall.”

In summary, actual inflation corrodes the value of bond payments, while expected inflation can cause market interest rates to rise and the market value of bonds to decline. Either actual or expected inflation can also cause the Federal Reserve to hike short-term interest rates, coinciding with inflation-caused increases in rates. Although inflation has been relatively low over the last several years, it does appear to be increasing. In May 2014, the core CPI reached 2%, which matches the highest level since 2012—by historical standards, this number is still moderate. There is some murky evidence that wage inflation is on the horizon, which can cause a longer-term rise in overall prices. Fed money printing between 2008 and the present, meanwhile, makes the economy more sensitive to other sources of inflation.

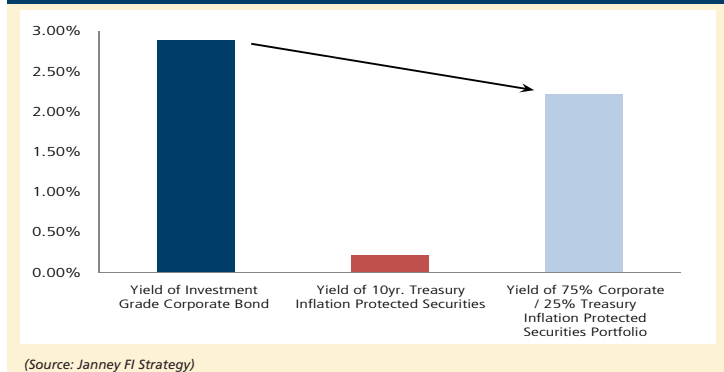
We don’t think inflation will rise sharply to the point where it significantly impacts interest rates and bond market values, but inflation does remain a risk—both in and of itself, and in causing the Fed to accelerate hikes in interest rates. There are a few simple ways to reduce the impact of inflation on your portfolio:

1. Sell longer-term and buy shorter-term bonds. The market value of long-term bonds is more sensitive to changes in inflation, so short-term bonds outperform longer ones if inflation rises. This strategy would reduce but not eliminate inflation risk.
2. Sell fixed rate and purchase floating rate bonds. Were inflation to rise, the coupon payments on floating rate bonds would increase, providing incremental income. The bonds’ principal payments would still be fixed, however, and therefore

sensitive to inflation. This strategy would reduce but not eliminate inflation risk.

3. Allocate a portion of portfolios to investments that benefit explicitly from higher inflation rates, such as TIPS (Treasury Inflation Protected Securities), CDs whose coupons are linked to the CPI or commodities. Owning a large portion of a bond portfolio in TIPS can fully immunize against inflation risk, but allocating a portion to inflation-linked bonds or commodities would reduce but not eliminate inflation risk.
4. Allocate a portion of portfolios to dividend-paying equities that benefit from higher inflation rates. Since higher inflation is often associated with faster economic growth, many companies can benefit from inflation by earning greater revenues and paying greater dividends. Once again, having a portion of portfolios in dividend-growth equity stores can reduce, but won’t eliminate, inflation risk.

Chart 2: Reducing Inflation Risk has a Cost to Current Yield



As always, reducing risk—in this case, inflation risk—in a portfolio involves tradeoffs. Investors can reduce their inflation risk with the above four strategies, but each of the first three will reduce current income as compared to an unprotected bond portfolio, and the fourth strategy will introduce equity market risk into the portfolio. We don’t expect that inflation will accelerate aggressively, but the potential for higher inflation rates at this time of economic transition does represent a risk for bond investors that’s greater than it’s been at any point since the Global Financial Crisis.

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