PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS
PARADIGM

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We consistently receive questions regarding how rising interest rates might affect a portfolio. This is a very complex topic that likely will take multiple years to unfold. However, this month we want to start a dialogue on this topic as it will be a major issue in the coming years.

Background

Below is a ten-year graph for the yield on the 10-year U.S. Treasury bond. The interest rate is on the vertical axis, which shows that the rate peaked in 2007 at around 5.3% and is currently at 2.3%.

For this discussion, we'll use the assumption of the Congressional Budget Office (CBO) that the rate on this bond increases to above 4% by the end of 2018 and that annual inflation at that time will approximate 2%.

Bonds

It's no surprise that future bond returns will decline from past bond returns as rates rise. This process has already begun. For the period ending December 2014, the ten-year return for the Barclays U.S. Aggregate Bond Index was 4.7% per year. For the three-year period ending December 2014, the index return was 2.7% per year.

Investors are not likely to own only 10-year U.S. Treasury bonds or a Barclays U.S. Aggregate index fund. High-yield bond funds and foreign bond funds may be appropriate for some investors as a way to improve returns. However, we believe investors ought to be thinking of five-year returns closer to the 2.7% figure than the 4.7% figure.

Stocks

The S&P 500 entered 2015 trading at 17.2 times estimated 2015 earnings. This is expensive by historical standards, but less so if interest rates and inflation play out as the CBO projects.

Rising rates cut both ways for stocks. Rising rates imply an improving economy that bodes well for stocks. On the other hand, rising rates imply that valuation levels (P/E ratios) need to decline as bonds become more attractive.

Assume that rising rates imply a good economy with reasonable earnings growth plus a slightly shrinking P/E ratio. In that environment, S&P 500-type stocks could return 7% per year. These expected returns are reasonable, especially in an environment of 2% per year inflation. By comparison, for the ten-year period ending December 2014, which included the Great Recession, the S&P 500 return was 7.7% per year and inflation was 2.3% per year.

Investors do not own only S&P 500-type stocks. Small-cap and foreign stocks plus portfolio rebalancing provide some flexibility for improving returns. Some investors can include real estate in their portfolio, which may also improve returns.

Deficit

Investors worry that the mounting U.S. deficit will result in an additional negative shock to financial markets as interest rates rise. Interestingly, rising rates will not impact the U.S. deficit over the next several years as much as you might think. The government doesn't have to refinance its entire debt in the next several years. In fact, the CBO projects that the average interest rate for the U.S. government will rise from 1.7% in 2015 to 2.7% in 2018. To be fair, though, post-2018 rising rates are a much bigger issue.

Summary

Rising interest rates will be a major concern in the coming years. However, if the current projection of slowly rising rates occurs, investors can prepare while adjusting portfolios and expectations.

We understand this first discussion is a view from 30,000 feet. However, as this issue unfolds and as we meet with clients, we can discuss how rising interest rates affects your specific needs.

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