Cherry Tree Wealth Management

(Formerly Adam Smith Advisors)

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CHERRY TREE WEALTH INSIGHTS: *Published by Keith Tufte, President of Cherry Tree Wealth Management, LLC, with insights on investing and wealth management.*

INVESTING QUOTE OF THE MONTH:

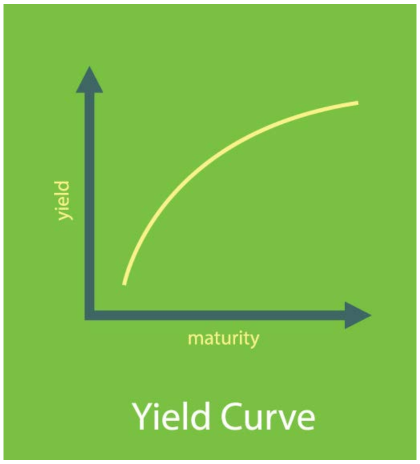
"On taking risk, never test the depth of the river with both feet." – Warren Buffett

THOUGHTS ON RISING INTEREST RATES

Interest rates have jumped up quite a bit over the past six months. The 10-year Treasury bond yield just hit 3% for the first time in many years, up from just 2.35% in November of 2017. Rising interest rates mean we have experienced slightly lower bond portfolio values this year, since bond prices move in the opposite direction of interest rates. What should investors do, if anything, about rising interest rates?

WHY ARE U.S. INTEREST RATES RISING?

1. The economy is stronger. A stronger economy generally pushes interest rates up. Economic growth has been strong for several years, and the recent tax cuts are likely to help keep U.S. economic growth strong in 2018.
2. The U.S. Federal Reserve has been increasing short-term interest rates. The Fed raised short-term interest rates for the sixth time in March to 1.5%-1.75%. They are likely to increase rates several more times this year and perhaps again in 2019.
3. The Fed has discontinued their quantitative easing (bond buying) program, and is now starting a quantitative tightening (bond selling) program.
4. The unemployment rate is low. A low unemployment rate (currently only 4.1%) generally results in rising wages, which tends to put upward pressure on inflation and interest rates.
5. Inflation is increasing. Rising inflation tends to push interest rates up. We have seen increases in the prices of goods that businesses buy (PPI), higher real estate prices and rent, and significantly higher prices in several commodities such as oil.



WILL INTEREST RATES CONTINUE TO INCREASE?

Very short-term (overnight) interest rates are controlled by the Fed, and they appear very likely to continue to increase over the next year. Intermediate-term and long-term interest rates are controlled by the market (buyers and sellers), not by the Fed. Nobody really knows whether intermediate and long-term interest rates will be higher or lower a year from now. They have not increased as much as short-term rates recently, resulting in a flatter yield curve. Medium and longer-term interest rates could be higher a year from now, roughly flat, or lower than today.

WHAT SHOULD INVESTORS DO?

We believe it is smart to hold short-term or intermediate-term bonds (not long-term bonds), because they are less affected by rising interest rates. Bond prices move in the opposite direction as interest rates, and the amount they move depends on the average length of the bond (in years to maturity). For example, if interest rates increase one full percentage point you could lose 3% on a bond with 3 years to maturity, but you could lose 20% on a bond with a 20-year maturity.

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Higher interest rates are bad for people who have many debts such as credit cards, auto loans, student debt, margin debt, and mortgage debt. They will end up paying more interest over time on their debt, especially if they have loans with adjustable interest rates. Higher interest rates could provide extra incentive for people to pay off some of these debts more quickly. Continued increases in interest rates could result in more severe drops in stock prices and housing demand compared with short-term bond prices.

We believe gradually rising interest rates are a long-term positive for savers and investors. Savers will immediately earn more on their short-term investments such as money markets, CDs, and very short-term bonds. Bond owners will make more money over the next 10 years if interest rates gradually increase several percentage points and then stay at those higher rates. If you own short term bonds, your yields adjust upwards pretty quickly as interest rates rise, giving you higher future income. Short-term interest rates have already increased quite a bit over the past six months, making short-term bond funds look pretty interesting now.

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Let's take a specific example using a short-term corporate bond fund. This fund has a current yield of 2.9%, and an average bond maturity (duration) of only 1.9 years. If interest rates rose a full percentage point over the next year, the bond prices in this fund would likely decline by "only" about 2% (due to the short 2-year maturity). However, as an investor you would still earn the interest of 2.9% on that bond fund, so you would end up still making some money in this fund even in a rapidly rising interest rate environment. In the very next year this bond fund is now yielding 3.9% (remember interest rates went up a full percentage point). Assuming interest rates stay flat in that year, you will now earn 3.9% in yield rather than 2.9% (the previous year), an increase of 33% in your interest income.

We believe the sweet spot of the current interest rate curve, where you get the most return (yield) for the interest-rate risk you are taking, is on bonds and bond funds with average maturities between two and five years. You get paid very little in extra yield to go out beyond five or six years in maturity, but are taking much higher interest rate risk. We also prefer to own higher quality bonds, rather than high-yield "junk" bonds. High quality bonds provide diversification and stability to your portfolio, and are much less risky than stocks. Historically, high quality bonds have often increased slightly in value in years when stocks have collapsed.

In conclusion, we think gradually rising interest rates are a positive for our clients' long-term expected bond returns. The vast majority of long-term bond returns come from the coupon (interest) payments, not the short-term price change caused by interest rate changes. Bond prices will suffer a little bit in the short-term (if you own short-term bonds) if rates continue to rise, but that will be more than made up for over the long term in terms of significantly higher interest income in the future.

Cherry Tree Wealth Management, LLC (CTW) provides unique wealth management services for a select group of client families to help give them peace of mind. Author Keith Tufte, (CIO of CTW) has over 25 years of successful investment management experience as a Wall Street Analyst, Mutual Fund Portfolio Manager, Director of Equity Research for a major mutual fund firm, Hedge Fund Portfolio Manager, and Wealth Management Advisor. Please FORWARD this e-mail to friends/relatives/business associates that you think may have an interest. Please see our website at http://www.cherrytree.com.

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