Debt strategies for new era after Fed tapering

Don't bail out of bonds because interest rates are rising – just adjust your investing tactics

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The announcement from the chairman of the United States Federal Reserve. Ben Bernanke, last week that the US central bank will start unwinding its money-printing programme, known as quantitative easing, had a big impact on bond prices.

As Bernanke made the comments, investors dumped bonds, and yields on 10-year US treasuries rose 17 basis points, or 0.17 percentage point.

Those accustomed to the daily swings of Hong Kong equities may think that is no big deal, but in the bond world that is an extraordinary rate move, which translates into losses for people holding those bonds.

In any case, bond investors would be looking at the trend, which has seen the yield on the treasuries rise to 2.35 per cent from 1.62 per cent at the start of last month.

The worm has turned. The Fed is winding down its US$85 billion-a-month bond-buying scheme and, barring another global financial crisis, there will not be another quantitative easing for a long time. Interest rates will now start to rise, eroding the value of all those low-interest bonds issued in the past five years.

Investors worried about rate rises might wonder what to do with their bond portfolios.

One obvious strategy is to buy short-dated instruments. The shorter the date for maturity, the less risk that investors will be caught out holding a low-yield instrument as interest rates rise.

As a rule of thumb, a 1 per cent rise in interest rates would lead to a loss of about US$6 in the value of a 10-year bond, US$3 for a five-year bond and about US$1.50 for a three-year bond.

For example, China National Petroleum Corp's bond maturing in 2018 lost only 1.3 per cent of its value last month, while its longer-term 2023 bond lost 6.5 per cent and the 2041 bond fell 11 per cent.

Yield on the move

Yield on 10-year US treasuries since the start of the year (%)

Source: Bloomberg SCMP

The market expectation is that the Fed will start raising rates in 2015, and only gradually. When that happens, a bond portfolio with a five-year maturity now would have only about three years of remaining maturity; and would escape more or less unscathed when the rates rise. At that time, investors would be able to reinvest proceeds from bonds in higher-yielding securities.

The second suggested strategy for bond investors is to overweight non-investment-grade bonds for the next 12 months to benefit from the higher yields.

It may sound counterintuitive to buy more bonds just as interest rates rise but high-yield bonds are less sensitive to the minute fluctuations in Treasury yields. If a bond yields 7 per cent, then a 0.5 per cent rise in Treasury rates is just a blip.

High-yield bonds are more of a bet that an issuer will honour its coupon and repayment commitments, and here the outlook is more positive. Moody's says the global default rate on global high-yield debt for the first quarter was 2.4 per cent, near a record low.

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