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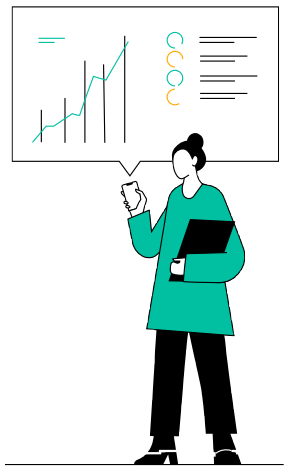
Bond portfolios and interest rates

You may be familiar with the relationship between bond prices and interest rates. A rise in interest rates makes the coupon rate on existing bonds less attractive, leading to a fall in price, while a fall in interest rates makes the coupon rate more attractive, leading to a rise in price.

This inverse relationship makes interest rates an important driver of bond market returns. Lower interest rates may be beneficial for borrowers but seen as a threat by bond investors. However, there is more to bonds than this seemingly mechanical relationship implies. To understand the impact of interest rate movements—either up or down—on your portfolio, you need to consider your investment horizon and broader investment objectives.

Are rising interest rates always bad for bond portfolios?

The overall effect of a rise in interest rates on a bond portfolio is ambiguous and, depending on your time horizon, may even be beneficial. In the short term, rising interest rates may lead to a fall in capital value, all things being equal. However, over the long term, the yield to maturity of the portfolio will increase. This is because income generated from coupon payments and maturing bonds is invested in new bonds with a longer yield. Over time, this can actually increase the overall return of the bond portfolio.



Rising interest rates

Immediate impact

- Higher yields mean the value of the portfolio's income stream decreases.
- The value of the portfolio falls, all things being equal.
- Portfolios with longer duration may suffer a larger fall in value.

Longer-term impact

- Income generated from the portfolio is re-invested in new, higher-yielding bonds.
- Yield to maturity of the portfolio increases.
- Higher income generated by the portfolio offsets the fall in capital value.

Stable interest rates

- Value of the portfolio's income stream remains stable.
- Capital value of the portfolio remains stable.
- Portfolio's yield to maturity remains stable.

Falling interest rates

Immediate impact

- Lower yields mean the value of the portfolio's income stream increases.
- The value of the portfolio rises, all things being equal.
- Portfolios with longer duration may enjoy a larger rise in value.

Longer-term impact

- Income generated from the portfolio is re-invested in new, lower-yielding bonds.
- Yield to maturity of the portfolio decreases.
- Lower income generated by the portfolio offsets the rise in capital value.

Not all parts of the yield curve are created equal

When assessing the impact of interest rates on bonds, it's important to distinguish between short-term and long-term interest rates. Short-term interest rates tend to be influenced predominately by central bank policies, while long-term interest rates tend to be influenced more by the market's long-term growth and inflation expectations.

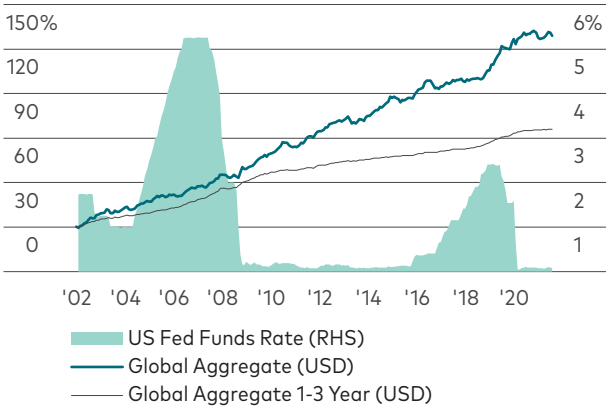
Short-term and long-term rates won't always move in concert. For example, it's possible for short-term interest rates to rise—reflecting a tightening in central bank policy—and for long-term interest rates to fall—reflecting the market's expectations for lower long-term economic growth and inflation.

Consider how bonds support your long-term investment objectives

Your investment timeframe is a crucial factor in assessing the impact of interest rate movements. In the short term, interest rates and yields may rise faster than the market anticipates, which could have a negative impact on the performance of your bond allocation. However, over your investing life, short-term market movements will be overshadowed by the long-term income generating effect that bonds provide.

There are also other important considerations, such as capital preservation, liquidity, and the need for a reliable source of income, that can be met through an allocation to bonds. Your allocation to bonds should be determined by your long-term needs and objectives, rather than short-term market movements.

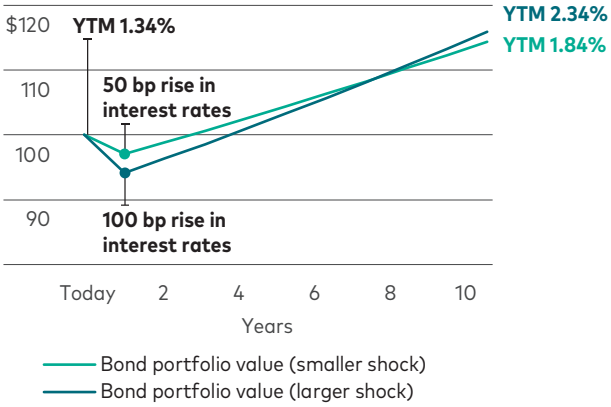
Figure 1. A rising cash rate does not necessarily mean negative returns for bonds



U.S. Fed Funds rate change and Cumulative Performance of Global Aggregate and Global Aggregate 1–3 Year.

Source: Bloomberg. Data as at 31 March 2021.

Figure 2. Long-term impact of an interest rate shock on a broad bond portfolio



Notes: Analysis based on the Bloomberg AusBond Composite 0+ Year Index with an initial investment of $100. Analysis assumes the interest rate rises apply to the yield of all bonds within the Index.

Source: Vanguard using Bloomberg data as at October 2021.

For more information

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