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A 1994 parallel?

The Federal Reserve has not yet announced when it plans to raise short-term interest rates. The fact that Gross Domestic Product grew by an estimated 4% in the second quarter suggests that the economy may soon be strong enough to begin returning to rates that are more normal by historical standards. The fact that the Fed has tapered off its bond purchases, and has announced that the program will end in October, also suggests that a rate change may not be very far off.

What happens to the bond market then? No one knows for certain, because this long period of very low interest rates is without modern precedent. But some market observers are looking to 1994 for clues.

Fortune magazine referred to that year as "The Great Bond Massacre" in an article datelined October 17, 1994. As the year began, bond yields were low, inflation minor, and the economy was healthy, in its 34th month of expansion. In February that year, the Fed began to nudge short-term rates higher. Long-term rates soon followed suit, rising from 6.2% in January to 7.75% in September for the 30-year Treasury bond. *Fortune* estimated that the value of U.S. bonds fell by $600 billion during that period. Other countries also experienced rising rates, and the worldwide loss of wealth was estimated at $1.5 trillion.

As interest rates rise, the value of previously issued bonds necessarily falls, that's just math. However, there are factors that can exacerbate the portfolio damage. In 1994 excessive leverage was fingered as one of the culprits, because it magnified the losses of those who had bet on stable interest rates. This year one concern is that some investors have been reaching out to riskier bonds with longer durations to improve their yield. That could make them more vulnerable to a rate upturn. Another concern is that mutual funds are now major players in the bond markets, and exchange-traded funds also have a role. Should investors start a stampede to exit the funds to cut their losses, that might exacerbate the problem.

Investors need to stay sharp, and not take their investment strategies for granted.

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