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The Advisor

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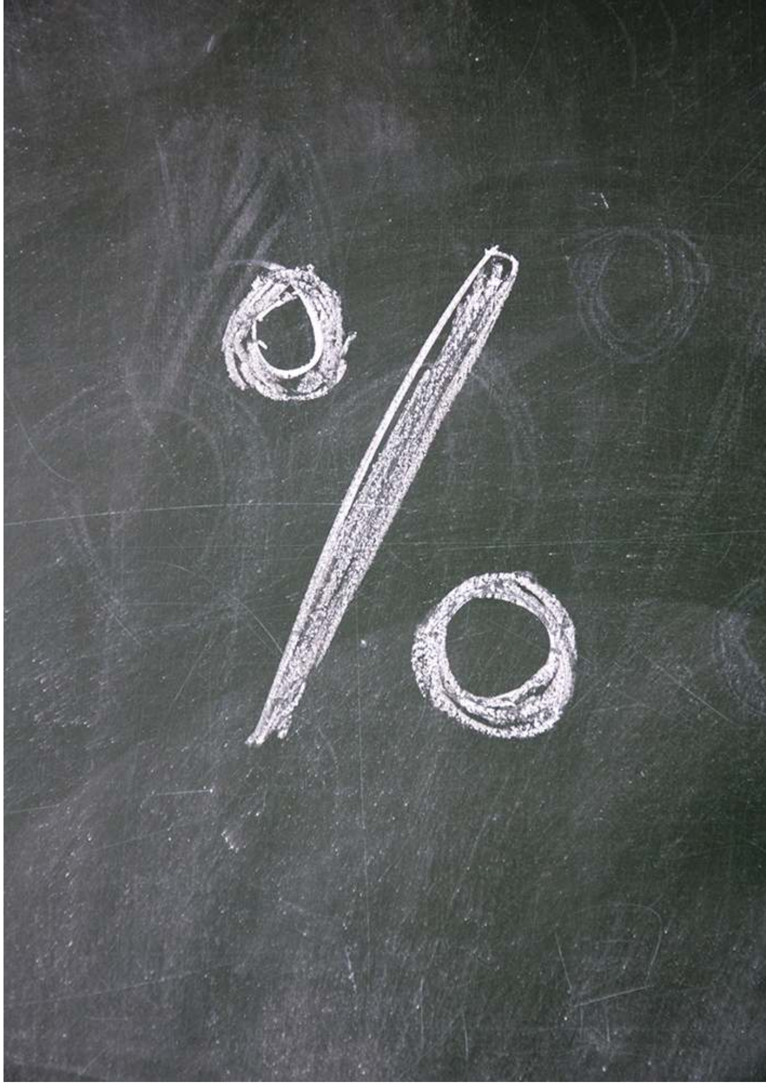
PHYSICIANS
THRIVE
INVESTMENT ADVISORS

RISING INTEREST RATES; IMPACT ON BONDS



After lots of speculation the last couple of years, interest rates have begun a slow climb out of the cellar, thanks to a more robust economy. It is a double-edged sword in many ways, with borrowing costs going up as economic stimulus simultaneously accelerates.
The Federal Reserve, under its new chairman Jerome Powell, has its eye keenly focused on the low unemployment rate and the threat of encroaching inflation. After near zero interest rates for years, these factors are forcing their hand.

Chairman Powell's recent remarks before the House Financial Services Committee were encouraging in terms of the economy and its direction, but that is where that double-edged sword can be found. This good news means that the Fed can see the prospect of increasing inflation and their answer is to raise interest rates. An overheated economy, means that the pace of rate increases has to increase, and that increases the risk of a recession, although slight.

The chairman indicated that four rate hikes may be in the offing instead of the planned three this year.

The factors that are prompting the Fed's new optimistic assessment include strength in the labor market, more stimulative fiscal policy and continued strength globally. The central bank's inflation goal is two percent.

The Fed's next meeting is in late March, when officials might firm up their estimate of rate increases for the year. Many investors also anticipate another rate hike coming out of this meeting. Some analysts also forecast three rate hikes next year.

Bond Yields

Consumer inflation, which hasn't been a concern in several years, has re-entered the picture with the more vigorous economy. Retail sales were off in January. Early February showed core inflation at 1.8 percent year over year.

Recently, we saw an increase in yields on the 10-year Treasury note. The price of existing bonds have fallen, sending yields higher. Those yields have been close to three percent recently. This can have an impact on the stock market as investors can be lured away from dividend-paying stocks to bonds.

Shorter term bonds usually see a decrease in demand as rates increase. Prices come down and yields go up. The impact of rate hikes on the longer 30-year bond (inflation protected) are not impacted as much. There is a merging though of the yields on the shorter-term bonds and the long bond.

While bond yields have become more attractive, the stock market continues to captivate investor interest, albeit, with more volatility. Rising interest rates can help regional bank stocks.

The stock market's performance, going forward, and the Fed's decisions will both determine how much interest bonds receive in the near future. All eyes are on the Fed to see if their decisions have already been priced into the stock market.

JUMP IN THE VIX; INVESTORS FEEL SQUEAMISH

The relationship between the stock market and the psychological mindset of investors is undeniable. The mood of investors, and their general sense for the future direction of stocks, plays a large part in the actual direction of the market. Part of the reason for this is that the mood of investors is tracked and reported. Ironically, this measure of certainty or uncertainty about the direction of the market ends up playing into the actual movements in the market.

How people feel about the market based on current events, or their sense of near future events, is a gauge of how investor psychology or mood might impact market performance. It can signal the level of volatility, which is something that determines what actions many investors will take as a reaction.

The CBOE Volatility Index*, better known by its ticker symbol "VIX," measures the stock market's expectation for volatility based on options trading of the S&P 500 Index**. The current level of the VIX is published by the Chicago Board Options Exchange (CBOE). Because of what the index measures, many refer to it as the "fear gauge."

The CBOE puts out information about the current level of the VIX on a daily basis. Traders can trade VIX options contracts and some exchange-traded funds (ETFs) are designed to track the performance of the VIX.

Recent Volatility

A focus on the VIX has been particularly important in recent months as more volatility has found its way into the markets. On February 5, 2018, a Monday, the VIX had its biggest one-day move, when it rose 20.01 points, which represented a 115.6 percent increase. It closed at 37.32.

The closest that previous records came to these numbers was a 16.54 percent increase in October of 2008 and a 64.2 percent increase in February of 2007.

You can see how the VIX correlates with actual activity in the market when you consider that on February 5, 2018, the stock market suffered its worst one-day point loss in history. The Dow plunged more than 1,100 points.

Everything is relative though, and the enormous point drop, on a percentage basis, didn't even make the top-20 worse days for the Dow. The two occurrences did point to a change in investor sentiment, which reflected some variables were present on that day.

One of these variables was speculation that the Federal Reserve was going to take a more aggressive stance towards raising interest rates. This would result in a marked decrease in consumer and commercial borrowing. Another was concern that many stocks were becoming over-valued. A third concern was the recent rise in 10-year Treasury yields. On the technical side, the losses during the day pushed the S&P 500 Index below its 50-day moving average support level.

In an age of computer-aided trading, a market in steep decline can trigger more sell-stop orders and the whole process becomes self-perpetuating. This can increase the magnitude of the selling frenzy on a particular day.

All of this volatility was in stark contrast to the levels seen just weeks before, when the VIX was below 10 and near historic lows.

An official correction in the stock market is when the market drops at least 10 percent. That indicator was met on February 8, 2018, when the markets losses had exceeded that number, down from a record high reached in January.

While the markets have seen more volatility as they try to find a path back to the momentum seen in January, the VIX is worth watching now that it has settled back to a level that may reflect a little more investor confidence.

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About the Author

K Richard Douglas has worked in the financial services industry for 26 years, with an additional 10 writing about financial and economic topics. He's a former series 9, 10, and 26 registered principal and series 6, 7, and 63 registered representative. Richard has held many financial service industry designations, especially in the retirement planning and compliance mechanism areas.