# Rate Prophecy

**Best not to sound too confident when predicting interest rates.**

I suppose a good number of young bankers learn this lesson once, and either get it right the next time, or are quickly out of a job. It was a simple question: "Should I lock in my mortgage now, or should I wait to see if interest rates improve for me?"

Fortunately I never specialized in mortgages – focusing on commercial projects during my bank life -- so this particular goof-up wasn't mine, but a colleague had the misfortune of opining definitively on the question. He replied with something like: "Oh I think you should lock in now. After all, 12% is a big improvement over the rates we've been paying for the past few years?"

The nineties was a decade of falling interest rates. A week or so after locking in his mortgage, the client was very angry to see mortgage rates fall another full percent, costing him no small penny over the term of his deal. Angry as an alligator in a shoe store, he complained vehemently to the bank manager, and – well let's just say it was painful for my colleague.

**Are rates going to continue rising?**
Every good economist starts the reply with something like: "Well, it depends." Generally, the extremely low rates of the past few years makes the upward trajectory seem more likely, but as recently published by RBC Economics: "interest rates are notoriously difficult to forecast – a *Wall Street Journal* study found that professional economists are not only unable to consistently predict the magnitude of interest rate movements, but that they failed to correctly forecast the *direction* of interest rate movements in two-thirds of the quarters over the past 30 years."

Although RBC forecasts rates regularly, we disclaimer them with short finely printed novels in the latter pages of each projection. I mean – it's an educated opinion, but the variables are just so many and varied that it is better to have the intelligent conversation without overstepping and claiming anything remotely resembling prophetic insight. In short, we acknowledge that yields could conceivably move in either direction from current levels as unpredictable economic conditions and market expectations change, but we talk more confidently about long term trends – and just a summary of the issues at hand.

**What are investors to do in fixed-income funds to limit downside risk if yields continue to rise?**
I borrow somewhat from a recent article published by RBC Wealth Management below:

We are strong proponents of diversifying fixed income investments across geographies and market segments.
-2.5%
**Geographic diversification:** In addition to expanding the investment opportunity set for our portfolio managers, a globally diversified fixed-income fund minimizes the impact of changes in monetary policy in any individual country on investment performance. For example, even if U.S. Treasury yields continue to increase, the impact on the performance of a Bond Fund may be mitigated by its holdings of government bonds issued in countries where rates may be stable or even declining.

**Asset class diversification:** While globally diversifying is useful, it is not the only strategy to deal with rising rates. For instance a sprinkling (within carefully-managed risk tolerance limits) of Highly Yield and Emerging Markets bonds can diversify exposure – behave differently -- to developed market government bonds.

**If I'm worried about losses, should I liquidate my fixed-income investments and hold cash?**
There are some scenarios in which it might be advisable for investors to hold cash, particularly in cases where the investor has a short investment horizon. However, cash can do a disservice to long-term investors for several reasons, most notably because it does not provide the downside protection that

bonds do (that is – bonds can sometimes rise in value in a substantial way during stock market declines) during equity market downturns, not to mention that it loses purchasing power over time due to inflation.

While the return potential of bonds is more limited than it has been historically, bonds continue to play an important role in a balanced portfolio due to their ability to preserve value in periods in which equity markets decline. As such, investors should continue to maintain a dedicated, well-diversified bond allocation in their portfolios.

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