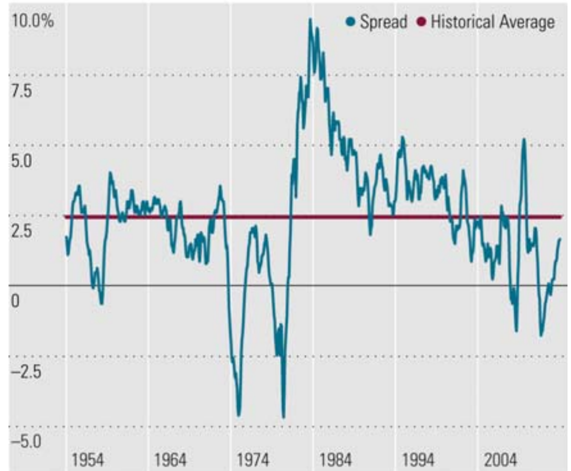
Fed Policy, Inflation, and Interest-Rate Risk

- Based on the relationships outlined here, the 10-year Treasury would be yielding about 4% presently instead of its 2.65% yield at the beginning of March.
- As the Fed tapers and the U.S. economy improves, yields can be expected to increase, which would negatively impact bond prices and therefore, bond returns.
- However, COMPASS has already positioned client portfolios so that the deleterious impact from such an environment is limited.

With interest rates still relatively low, the question today is by how much they are likely to rise. Historically, the 10-year Treasury bond has yielded, on average, about 2.5% over the inflation rate. With inflation at 1.5%, the 10-year Treasury bond typically would yield about 4.0%. In an attempt to support economic and job growth, the Federal Reserve has been purchasing long-term Treasury and mortgage-backed bonds to artificially keep interest rates low. As long as the Fed kept this asset purchase program up, 10-year Treasury yields remained relatively low. However, the Fed has begun tapering, and interest rates are likely to rise significantly in the near future. Both investors and advisors should be aware of the implications of rising interest rates.

Spread of 10-Year Treasury Over Inflation



Treasury bonds are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest.

Source: 10-year Treasury yield data from the Federal Reserve. Inflation is represented by the Consumer Price Index, three-month rolling average, and data from the Federal Reserve. The time period displayed in the chart is January 1954 to December 2013.

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