Registered Investment Advisor Firm

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Bond Ladder

Speculating on the direction of interest rates is a popular sport in the bond market. But it is proving a challenging one lately. The US economy is positively moving forward, and when that happens, bond interest rates usually rise. But not this time. For 2019 first quarter, Gross Domestic Product (GDP) increased at an annual rate of 3.2%, compared with 2.2% in 2018 fourth quarter. But the 10-year bond rates declined – from 3.1% in mid-May 2018 to 2.4% a year later.

One explanation may be a disconnect between economic growth and inflation. Despite moderate-to-good GDP increases, inflation has been tame for seven years now, averaging just 1.6%. Or perhaps businesses and investors are expecting the economy to cool off. Recall this expansion is now the longest in at least 165 years. The current consensus estimate of economists surveyed by Blue Chip Economic Indicators is GDP growth of only 2.3% this year.

The reason bond investors focus on where interest rates are headed is that bond prices move in the opposite direction of interest rates. As an example: if you buy a $10,000 Treasury bond yielding 5% and rates rise to 10%, then your bond will not be worth as much if you sell it before maturity, its market price will need to fall. Why? Investors will be able to buy a current bond paying $1,000 interest each year, compared to your $500. So, your bond price has to fall so the bonds are equivalent in yield.

Think of bonds as adding ballast to your balanced portfolio. They provide your portfolio stability, no matter where interest rates are headed. Stocks and bonds are classic uncorrelated assets. When stocks rise, it usually indicates that optimistic businesses and consumers are doing more borrowing and anticipating more inflation, which in turn means higher interest rates, therefore lower bond prices. Conversely, when the economy slows, rates fall, so bond prices rise. High-quality bonds should be the safer part of your portfolio.

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The best way to protect yourself from interest rate risk is to build a bond ladder. This dampens the risk no matter the direction of the market. Say you have $50,000 to invest in bonds, do not put all the money into bonds that all mature in the same year, spread out the maturities over many years. Depending upon your income needs, you could spread maturities over 5 to 10 years. Buy $10,000 bonds that mature each year for the next 5 years. When the one-year bond matures, take the proceeds and buy a new bond that matures in 5 years. If rates have risen, that new bond will pay more than the last. And you will not lose if you have to sell your bond portfolio early.

One positive about the ladder is if rates rise and prices fall, as each bond approaches maturity, its price will rise back to par value, no matter what rates are doing. If rates fall and prices rise, you can sell the bonds before maturity for a profit.

The type of bonds depend on your income needs and risk tolerance. High quality corporate bonds give you high income with some safety. High yield, or junk bonds, can yield higher income, but with less safety and government bonds will yield less, but offer more safety. Municipal (muni) bonds can provide tax-free income and double tax-free income depending upon your state of residency, meaning no state or federal taxes are paid on the income. A combination of some or all of the above is good, depending upon your needs and goals.

Depending upon the type, bond mutual funds hold longer maturity bonds and are not laddered, so when prices are down, the value of the fund will stay down till rates fall, sometimes taking many years to recoup losses.

If you need help with understanding bond ladders or any other financial questions, contact me at (707) 648-2024.

Q: How can grandparents help their grandchildren pay for college?
A: Direct Contribution. With the annual gift-tax exclusion, each grandparent can give up to $15,000 to each grandchild in 2019 free of gift taxes. A couple can gift $30,000 to each grandchild without tapping into the lifetime gift-tax exclusion ($11.4million per person in 2019). Tuition paid directly to the college also avoids gift tax.

If you pay the tuition directly or give money to your grandkids, that money may impact financial aid. It may be deemed as either cash support or a resource, depending upon the college or university classification.

Cash support can be treated as student income. But if you wait 2 years, the money won't impact financial aid because the Free Application for Federal Student Aid (FAFSA) form only assesses income from the 2 years prior. If it's deemed a resource, your gift immediately reduces financial aid dollar for dollar.

Contributing to a 529 plan. If a 529 college savings plan is owned by the

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student or parent, the plan is treated as a parent asset on the FAFSA with a maximum impact of 5.64%. You could "superfund" the 529, which allows you to gift five times the annual gift-tax exclusion amount at once. For 2019, this means up to $75,000 into a 529 for each grandchild. The lump sum will be treated as if it were given over a five-year period.

Paying student loan debt. You can't pay student loan debt directly, but you could always gift money to cover the debt to your grandchildren. Again, because of the FAFSA two-year lookback, wait until after the grandchild's sophomore year or after graduation to help pay the loan. Money in a grandchild's 529 plan used to pay off student loan would be a nonqualified distribution. Because taxes and penalties are assessed on the earnings portion of the distribution, there might not be any financial repercussions from the nonqualified distribution if money was contributed recently.

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FED Watch

The FED cut interest rates for the third time this year, as expected, in a move to ensure the US economy weathers a global trade war without slipping into recession, but it signaled its rate cut cycle might be at a pause.

The FED lowed its rate by a quarter-point to a range of 1.50% to 1.75%, and dropped a previous reference that it "will act as appropriate", language that was considered a sign of future rate cuts.

The FED will "monitor the implications of incoming information for the economic outlook as it assesses the appropriate path", a less decisive phrase.

The FED's description of the US economy remains largely unchanged, with labor markets "strong" and economic activity "rising at a moderate rate".

The FED will continue to take action to reduce borrowing costs "in light of the implications of global developments for the economic outlook as well as muted inflation pressures". The FED also said business investments and exports remained "weak".

The central bank and the US economy are at an unusual juncture. Unemployment is near a 50-year low, inflation is moderate, and GDP grew at an annual rate of 1.9% in the third quarter, a slowdown from the first half of the year but not as sharp a decline as many economists and some Fed officials feared.

But parts of the economy, particularly manufacturing, have slowed in recent months as the global economy slowed. Businesses have pared investment in response to the US-China trade war that both raised tariffs and made the world a riskier place to make long-term commitments.

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While that has not had an obvious impact yet on US hiring or consumer spending, Fed officials felt a round of "insurance" rate cuts was appropriate to guard against a worse outcome. The FED cut rates in July and September, and by doing so hoped to encourage businesses and consumers with more affordable borrowing costs.

There is only a 20.2% probability of a cut at the December meeting.

Next meeting:
December 10th and 11th.

Castle Rock Wealth Management

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If you have questions or would like further information on this month's topics or any other financial or investment related subjects, please contact me by phone or through my email address at:
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