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How interest rates affect bond funds

In this newsletter, we regularly discuss anticipated changes in financial markets and their potential impact on investors. One aspect of economic markets that we continually monitor is interest rates, as they can have a significant effect on the returns of bond funds in your portfolios.

What's happening with interest rates?

The Bank of Canada began its tightening cycle in early 2022 due to high levels of inflation within the economy. Despite inflation readings coming down, the Bank of Canada has reiterated that interest rates will remain higher until inflation reaches their 2.00% target. Currently, the Bank of Canada's interest rate has reached 5.00% and there is a possibility of more to come.

While rates are high, it is believed we are nearing the end of the tightening cycle where rates are expected to hold or decline. Many leading experts believe that an economic recession is expected to take place in 2024 which will allow the Bank of Canada to start reducing interest rates to a more neutral level.

High interest rates allow for strong forward-looking returns

Due to rising interest rates in 2022, bonds underperformed, with most posting negative returns during the year. Despite a potential for more rate increases, the impact is subdued due to higher interest rates today. For example, if the price of the bond declines by 1% but you earn 1% interest, then your return is zero. This is positive for both the short-term expectations and the longer term returns of these funds. If interest rates remain high, investors receive a high yield on their bonds, or if interest rates decline, it generates capital gains on their bond holdings.

The forward-looking expectations are most applicable to investors who hold a conservative market-based fund such as a Conservative or Moderate Asset Allocation Fund, a Retirement Date Fund approaching its year of maturity, or bond/fixed income funds.

Positioning for retiring members

Depending on the gains or losses seen within the member accounts to this point, members who are soon to retire could be at risk of realizing investment losses from the previous year. It is expected that yields and market appreciation will be positive going forward, so bonds are expected to provide both capital preservation and income over the longer term.

As always, we suggest that members review their portfolio on a periodic basis to ensure it is well-positioned to withstand market conditions and volatility.

We urge members who are closer to retirement to review on a more frequent basis, with the assistance of one of our licensed investment representatives.

To discuss your retirement portfolio and investment strategy, contact Reuter Benefits by phone at 1-800-666-0142 or by email at retire@reuterbenefits.com.

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