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INSIGHTS

A PRIMER ON THE FIXED INCOME MARKET

Although it is followed less closely by the media, and not as well understood by the general public, the fixed income market is actually larger than the equity market. According to the Securities Industry and Financial Markets Association (SIFMA), the US bond market is estimated to be worth $47.2 trillion vs the US equity market capitalization of $40.7 trillion. Within the fixed income market, there are different asset classes that each have their own set of unique characteristics.

Any fixed income portfolio essentially has two key risks, interest rate risk and credit risk.

Credit risk is the risk that the issuer defaults, which means that they may be unable or unwilling to meet their coupon and/or principal payment obligations.

Interest rate risk is the risk that an investment's value will change due to a change in interest rates. Investors are often most concerned with interest rate risk.

Treasuries are debt obligations issued and backed by the full faith and credit of the US government. Because they are considered to have low credit or default risk, they generally offer lower yields relative to other bonds. On the other hand, they are highly sensitive to changes in interest rates.

Agency bonds are issued by either agencies of the US government or government-sponsored enterprises (GSEs), which are federally chartered corporations but publicly owned by stockholders. They are also highly sensitive to changes in interest rates.

Municipal bonds are debt obligations issued by public entities that use the loans to fund public projects such as the construction of schools, hospitals, and highways. Municipal bonds are exempt from federal taxes and from most state and local taxes.

Corporate bonds are debt obligations issued by corporations to fund capital improvements, expansions, debt refinancing, or acquisitions.

High yield (non-investment-grade) bonds are from issuers that are considered to be at greater risk of not paying interest and/or returning principal at maturity. As a result, the issuer will offer a higher yield than a similar bond of a higher credit rating and, typically, a higher coupon rate to entice investors to take on the added risk.

Floating rate loans are debt obligations issued by banks and other financial institutions that consist of loans made to companies. They are called "floating rate" securities because the interest rates on the loans adjust at regular intervals to reflect changes in short-term interest rates as tracked by commonly accepted measures such as LIBOR (London Interbank Offered Rate). Because the loans can adjust, they are less sensitive to interest rate changes.

continued on page 2

INSIGHTS

In the US, short-term interest rates are strongly influenced by the Federal Reserve (or "the Fed"), which was created by Congress to provide a flexible and stable financial system. The Fed implements monetary policy by influencing money and credit conditions in the economy with the goal of full employment and stable prices.

The fed funds rate is the rate at which banks can lend each other money overnight. During a period of slowing economic growth, the Fed may decide to lower the fed funds rate to help stimulate the economy. If the economy is growing too fast, resulting in high inflation, the Federal Reserve may decide to raise the fed funds rate in an effort to slow down the economy.

Long-term interest rates are primarily influenced by long-term expectations for US economic growth and inflation. They may also be affected by current long-term global market rates.

Historically, bond prices and interest rates move in opposite directions. This happens because as interest rates rise, newly issued bonds carry a higher coupon, or stated interest rate, than previously issued bonds, causing prices of older bonds to drop as they become relatively less attractive to investors. More simply put, investors can earn more money in the form of interest payments on the new bonds than the old bonds. In the opposite scenario, when interest rates fall, older bonds become relatively more attractive than newly issued bonds because they offer more income.

Within fixed income, each of these asset classes has its own set of unique characteristics and risks, and the best-performing fixed income asset class often changes from year to year. Just like the equity portion of an investor's portfolio, it's important to have broad diversification across many fixed income asset classes.

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