FINDING COMMON GROUND AFTER UNCHARTERED WATERS

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In April of 2009, the Vice Chairman of the Board of Governors of the Federal Reserve gave a speech at a conference in Nashville that started with …

"In response to the financial turmoil and economic weakness of the past 18 months, the Federal Reserve has taken unprecedented steps in conducting monetary policy. Not only have we reduced our target federal funds rate aggressively, essentially to zero, but we have also made credit available to institutions and markets in which we had not previously intervened."

Coming from The Fed (an institution that almost never made headlines) this was a bombshell. Even Hollywood eventually weighed in with its dramatic interpretation of the events at that time with movies like the "Big Short." What is even wilder is the fact that previously innocuous actions of the seemingly sleepy, even boring government agency would become of critical importance and make headlines on a regular basis for almost a decade to come.

Which brings us to today, when our economy has strengthened and the reversal of these actions over the past decade is necessary. On the heels of unprecedented monetary policy, most would agree that interest rate risk is elevated. Big, important questions linger: How will the economy react? What are the right moves? How should financial professionals make sure they are continuing to act in their clients' best interests? — just to name a few.

With that in mind, below are a few concepts that may be useful in establishing a common understanding with clients when addressing such questions. This exercise may help financial professionals differentiate themselves in a best interest world, too. After all, if your clients understand why you make recommendations, aren't they more likely to trust that you are acting as their fiduciary, even when circumstances outside of your control cause unintended results?

MONETARY POLICY

Actions taken by a nation's central bank on a macro-economic level involving the money supply and interest rates on debt securities issued by the respective government are called monetary policy. In the United States, the stated objectives of our central bank (The Federal Reserve) are maximum employment, stable prices, and moderate long-term interest rates.

RATE NORMALIZATION

After the Great Recession and the unprecedented action taken by the Federal Reserve to create synthetic economic tailwinds using interest rates, the time has come to put things back in order. The Fed refers to this process as rate normalization. It is a careful and measured approach to increasing interest rates on U.S. Treasurys in a manner in which the economy and financial markets will not be too upset.

INTEREST RATE YIELD CURVE

A yield curve is a graph that plots a bond's yield and the length of time until it matures. Many types of yield curves exist, but the most commonly referenced illustrates the return of different U.S. Treasury Debt Securities. It provides valuable insight into what investors feel about bond investments and the overall health of the economy.

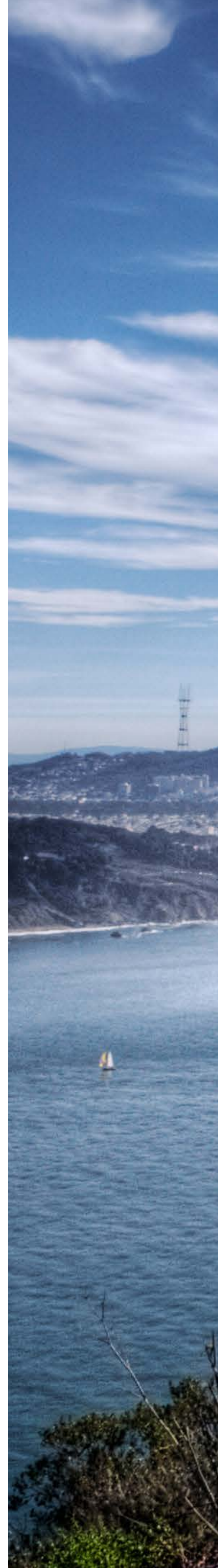
A yield curve with a rising slope means that long-term bond yields are higher than short-term. This indicates a higher demand for short-term bonds and a lower demand for long-term bonds. Congruently, if long-term bond yields increase quickly a yield curve gets steeper. Usually this means the economy is heating up and the demand for bonds with maturity dates farther into the future is lower. An inverted yield curve is the result of higher rates for short-term bonds and lower rates for long-term. Over the past five decades inverted yield curves have been indicators of a coming recession.

NORMAL YIELD CURVE

INVERTED YIELD CURVE

YIELD SPREAD

Often referred to as the credit spread, the yield spread is the difference between the yields of two different bond investments. It is used to determine a relationship between the debt securities. Bonds that are not issued by the U.S. Treasury are often compared to Treasury debt with the same maturity to determine corresponding risk. For example, if a bond A is yielding 4% and bond B has a 6% yield, there is a 2% (200 bps) spread. Investors can then use a historical perspective to interpret the level of risk embedded in the investment.



DURATION

A bond's duration is measured in years and it demonstrates the moment in time at which the investment is immune to reinvestment risk and interest rate risk. The higher the duration, the more a bond's price will move as rates change. More than anything else, it will demonstrate the sensitivity of a bond to rate fluctuations.

CONVEXITY

While duration is a powerful tool used for describing a bond investment's sensitivity to changes in interest rates, it does not tell the whole story because it suggests a linear relationship between price and yield. Convexity takes this thought process a step farther and measures the curve of the plotted line that illustrates the relationship between price and yield. Therefore, it indicates the estimated change in duration as interest rates fluctuate.

One way to think about convexity is as if you are climbing a mountain. As your elevation increases, the amount of oxygen in the air decreases. But the higher you go up the mountain, there is greater decrease in oxygen with every step.

That is to say, if someone goes from 3,000 feet to 4,000 feet, they probably won't even notice the difference. But when someone goes from 13,000 feet to 14,000 feet, the change is likely to be very noticeable.

In essence, a bond investment's convexity is very similar except elevation and oxygen level are traded for price and yield.

HARBORING ON COMMON GROUND

When working with clients to help them prepare for their financial futures, it is important to consider many different vantage points. To clarify these different perspectives, it is often a good idea to establish common ground on at least a few key points. Building on this foundation will lead to more constructive conversations, uncover new opportunities for action and hopefully help financial professionals with their business over the long term. Transamerica is here to help. We have a suite of products and solutions across a number of different lines of business that could prove useful for financial professionals who are assisting clients as they save, invest, protect, and retire.

When it comes to preparing for the future, there's no time like the present.

Let's get started today.

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