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What Fed rate hike, bond selloff mean for DFW investors

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The Federal Reserve, led by Chairman Kevin Warsh, initiated its first interest rate hike in three years on Sept. 16.
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The Federal Reserve hiked interest rates for the first time in three years on Sept. 16, providing another twist in what has been a volatile year for bond investors.

Bond yields have climbed in recent months amid inflation pressures fueled by geopolitical tensions. The Fed's latest hike in the benchmark interest rate signaled borrowing costs could remain higher for longer. While for some investors that may be concerning, others see it as an opportunity to shift their portfolios. They could move their money from bonds to stocks. Some managers recommend staying the course and locking in today's yields and actually putting more money into fixed income.

Amid a prolonged bond selloff, longer-term Treasury yields have climbed to levels not seen since the mid-2000s. The 30-year Treasury yield reached 5.4% on Sept. 14, its highest level since 2006, according to CNBC. Meanwhile, the 10-year Treasury yield, a key benchmark for mortgages, auto loans and other consumer borrowing costs, hit 5.04% on Sept. 15, its highest level since 2007.

Kevin Warsh, who recently took on the top role as chairman of Fed's board of governors, has also signaled a more hawkish approach to monetary policy.

Chris Gunster, head of fixed income at Dallas- and Tampa-based Fidelis Capital, said the recent rise in bond yields has been driven largely by persistent inflation and those hawkish monetary moves. Prices for many items have climbed accelerated since the outbreak of the Iran conflict, raising inflation expectations among investors. Diesel prices, in particular, have jumped sharply, he noted.

Against that macroeconomic backdrop, Gunster said corporations have also raised large amounts of debt to support the buildout of artificial intelligence.

The Fed's hike of 25 basis points had already been priced in by the market, Gunster said. He added that the market is expecting a couple more, for a total of three including today's by the end of 2027.

For investors in Texas, Gunster said the absence of a state income tax is a bright spot, especially for municipal and corporate bonds. As those tend to move with national markets, Texas investors get to keep more of their income than investors in other states.

"You're in a better off position than some of the other bonds," he said.

Year-to-date returns on Fidelis' taxable and municipal bond portfolios are roughly flat, in line with major bond indexes, as higher interest has offset price declines caused by rising yields. With yields now at elevated levels, that interest income should act as a tailwind and help drive positive returns for both municipal and taxable bonds going forward.

"It's a big tailwind for bond returns when yields are this high," he said.

Gunster recommends investors stay the course, reinvest income at today's higher rates and use the volatility as a chance to lock in richer yields rather than retreat from bonds.

"With diesel prices the highest they've been, energy prices in particular the highest they've been, inflation expectations on the rise – all of that negativity has already been priced in the market," he said. "Ignore the volatility and focus on the income that's being derived by fixed income, and in particular in the muni bond space."

Looking ahead, Fidelis expects short-term rates to move modestly higher as the Fed nudges the federal funds rate up, with longer-term yields staying largely range-bound.

At Dallas-based True North Advisors, Chief Investment Officer Dhruv Maniktala said the firm was "surprised it took this long for yields to go up."

With about 70% of U.S. debt needing refinancing within five years, and foreign holders now net sellers while the Fed no longer buys the way it used to, Maniktala said yields have to rise to attract yield-conscious investors. At the same time, that dynamic can create a "doom loop" where each refinancing at a higher rate pushes rates higher still, and "you cannot lock in interest rates for a long period of time."

Bonds remain the smallest slice of True North's roughly $6 billion in assets – about 20% to 25%, against 30% in stocks and the remaining half in private investments and alternatives. But that bond share is edging up.

"The 20% ... may go up to 25%, because we like it a little bit more," Maniktala said.

He said the firm is already moving in that direction, but added that he favors short-term bonds in the three- to five-year range rather than long-dated paper, so the money can be reinvested at better rates if yields keep climbing.

Four years ago, when rates sat at 1% to 1.5% – the lowest levels in 150 years – the firm held almost nothing in bonds, Maniktala said. At roughly 5%, yields are back near where they averaged over the past three or four decades.

On the firm's overall outlook toward the bond market, Maniktala said, "short term we are neutral to positive, long term we are still negative. But we were very, very negative a few years ago, now we're just less negative."

While higher yields may pay back investors, Maniktala says they're a serious problem for the broader economy, which spent more than a decade priced off interest rates near 1.5%.

Housing is the clearest casualty. Buyers who could manage a 3% mortgage can't afford 7%, prices haven't adjusted and sellers won't budge, slowing transactions.

The next strain is corporate. Companies that borrowed at 1% to 2% over the last decade must refinance in the next two or three years at 5%, and many "cannot even afford the high interest payment," he said, which he expects to slow parts of the market, particularly real estate and heavily indebted firms.

Inflation, meanwhile, is "really lowering the standard of living for people."