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Simmons Investment Advisors

Bond Market Update

Good Morning,

James Carville, a political advisor to President Clinton, is famous for saying "I used to think that if there was reincarnation I wanted to come back as the president or the pope or as .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." In recent weeks, the bond market has been intimidating the stock market.

In theory, stocks are valued based upon the present value of their future earnings. So, if you wish to know the value of a stock, you project their earnings, and then discount those back to the prevailing rate of interest. A higher rate means that the present value will be lower than if the interest rate is low. In recent times, interest rates have been very low, which helps to justify very high stock valuations. Recently however, interest rates have risen precipitously and as a result stocks, and especially stocks with lofty valuations and growth projections, have fallen.

This of course begs the questions as to why rates have been rising. The bond market is afraid of one thing: inflation. The economy has been doing well, with GDP projected to be as high as 7% in 2021. Vaccinations are accelerating, and there is clearly some light at the end of the tunnel. A $1.9 trillion dollar stimulus package is working its way through Congress and will likely pass. And the Federal Reserve has committed its self to keeping short term interest rates low for the next year or two. To the bond market, this looks like a combustible mix which could lead to inflation.

For the investor, this means a few things. In the short term, rising rates means even high quality bond prices will fall. However, if you hold them to maturity, you will receive your principal back and the yield you invested at. For the stock investor, rising rates pose the most danger to high valuation aggressive growth stocks. In the scenario, stocks with steady growth, reasonable valuations and dividends should do better. That said, rates have probably risen too far too fast, and it would not be surprising to see them fall back and allow the stock averages to recover.

As always, if you would like to talk about this more, or have questions on any other topic, please don't hesitate to give us a call.

Sincerely,

Ed, Mike and Steve

HIGHTOWER
Simmons Investment Advisors

Two Monument Square, Suite 503
Portland, ME 04101
(207) 228-7950
simmons.hightoweradvisors.com