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Thursday, Jan 22, 2004

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Don't get hit by falling rates

Stay with short term and renew when rates turn around

Jonathan Chevreau

Financial Post

Thursday, January 22, 2004

Depending whether you're a borrower or a lender, Tuesday's quarter point (0.25%) drop in the bank rate to 2.5% was a promising portent or an ominous sign. Every drop in rates rewards those in debt and punishes savers.

Homeowners playing mortgage roulette at the short end will be encouraged to stay short in variable mortgages for at least a few more months; retirees will feel further squeezed by rates close to the lowest in a generation.

Prudent souls parking wealth in liquid vehicles like money market funds or treasury bills now suffer further punishment for their caution. Those with

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long-term bonds, bond mutual funds or preferred shares get more bang for their buck with each drop in rates.

While tiny in magnitude this time around, the interest rate direction is a 180 degree turn from the climate last summer, when bond traders feared American interest rates had finally hit bottom and were poised to rise sharply. If they had (as they had begun to do in mid-2003), holders of long-term bonds would have suffered significant losses.

The lesson for investors in bonds appears to be the same as with stocks: don't fight the Fed. When Alan Greenspan says he'll keep rates down around 1% for some "considerable time," believe him.

Meanwhile, the Bank of Canada is "taking back" some of its rate hikes from 2003, imposed when inflation appeared to be heating up, says Vince Hunt, a fixed-income manager at AIM Trimark Investments. The bond market is pricing in at least another 50 basis points in cuts for upcoming meetings in March and April, he says.

When that happens, homeowners may get another chance to lock mortgages in for longer terms at still near-historic lows.

However, Burlington-based mortgage consultant Ron Cirotto (www.Amortization.com) says if forced to choose between a fixed and variable mortgage, he'd still stay short in the latter.

If you're on the receiving end of interest payments, those with ladders of bank GICs or strip bonds coming up for reinvestment may stay short. Rates could stay low another year or two but at some point will start to rise and present more attractive reinvestment opportunities than now.

Every time rates fall, yield-starved investors reach for higher returns. If so, the dynamics are in place for Income Trust Mania, The Sequel.

Similarly, mutual fund bond managers are juggling returns with investment grade corporate bonds and higher-yielding "junk" bonds. The lower the credit quality the less interest-sensitive bonds tend to be. Thus, business fundamentals have more impact on such firms than rates, says Dan Hallett, president of Windsor, Ont.-based Dan Hallett & Associates Inc.

Bond managers fall into two camps right now, Hallett says: those who think there is more risk in bonds than stocks; and those who think rates will be stagnant for few years and if they do rise, will do so only marginally.

For now, fears of a crash in the bond market are on hold.

The rate cut reveals how the soaring loonie is impacting the economy, says Norman Rothery, publisher of The Stingy Investor. "We appear to be in for a period of stable or declining rates in the short term ... the real danger in the longer term is inflation and increasing rates."

If yields "back up" and rise again, causing bond prices to fall, long-term bonds would lose the most, as occurred in mid-2003. Apart from that risk, historical data reveals little compensation for the greater risk taken on longer maturities, Hallett says. Thus, many advisors recommend clients stay in bond funds with maturities of five years or less.

Rate cuts give bond fund holders a short term bounce but "bond funds will

continue to eke out modest returns" in the optimistic case of long term stable rates, Rothery says. So he favours low-fee "frugal funds" from firms like PH&N, Leith Wheeler, Legg Mason and Barclays. "Should bonds yield 5% , you don' t want to see almost half of your interest going to pay fund fees."

High fees and low rates also make returns of money market funds look even punier next to high-interest bank accounts like ING Direct' s.

"People wanting to play the variable game with their mortgages are best to de-emphasize investment assets that are strongly, inversely related with interest rate changes," Hallett says.

"Or, if one is more comfortable with trusts and bonds in the portfolio, perhaps they should consider locking in a rate on the mortgage."

I couldn' t put it better myself, so I won' t attempt to.

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