

Warning Sign #1: Interest Rates

The Air Force's 53rd Weather Reconnaissance Squadron, the famed Hurricane Hunters, assesses and analyzes oncoming hurricanes. They fly into the teeth of these mega-storms, often packing winds in excess of 100 miles per hour, to accumulate density, wind speeds, ground speeds, trajectory, and all manner of other data. Then they compute when the storm will make landfall and how severe it will be.

Like a hurricane, the bond market's coming nuclear winter without a doubt will be a financial calamity. Like the 53rd Squadron, we know this one is coming. What no one knows is the precise date it will make landfall or just how long it will last.

Interest Rate Movement

Interest rates are at generational lows. They will rise in the foreseeable future. As rates soar, bond prices will plummet. For bond investors who say they will hold their positions until maturity, the rate hike by itself won't affect them all that much—until it happens.

The scary part of rocketing interest rates is the devastation it brings to *portfolio values*. This is a psychologically damaging event for investors. How would you like to see the value of your bond portfolio drop by half over a short period—say just three months? It could happen.

Investors will begin wondering if it will ever come back. They'll begin to feel poor, at least less wealthy. Investors are also consumers. They will consume less. And they will worry how to recoup their losses. Then the real concern surfaces: As if portfolio erosion wasn't bad enough, what happens if the bonds begin to default? That loss of principal along with the devastated portfolio value will send bond investors into pure, unadulterated panic.

Attempting to save the value of their portfolios, they'll begin selling into a plunging market—ostensibly before it goes any lower. Investors will trade bonds they know, have lived with for some time, and whose coupon payment history hasn't yet been compromised. Investors will console themselves that at least they stopped the hemorrhaging. No, they didn't.