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Bond Pricing

The current news ranges from increases in the price of oil and the Fed funds rate to the absurd testimony of Kenneth Lay, the former chief of Enron. My focus this month is on bonds, which are intimately connected to the Fed funds rate but first I want to touch on the price of oil and Kenneth Lay.

Oil has gone above \$75/barrel and there is no end in sight. The producing regions are very unstable politically and there is an ever-increasing demand from the industrialized nations. Kenneth Lay, well, he is in a class all by himself when it comes to blaming others for the demise of Enron. This former chief executive is now blaming the newspaper reporters for Enrons problems. That is hard to write with a straight face!

Enough of that, let's talk about bonds. When we purchased a bond for \$10,000 it has a yield and a maturity date. The maturity date is a date certain in the future when our \$10,000 will be returned to us. The yield, let's say 5% or \$500 per year is the amount of money we will get paid for each year or part of the year we own the bond. This money is split into two payments six months apart.

The important part about a bond is that the payment is fixed, hence the term 'fixed income'. Regardless of what happens to the price or market value of the bond the income payment, in our case \$500 per year, remains the same. The other important part about a bond is that regardless of what the market price does between the time we buy it and the time it matures, it will mature at \$10,000. The whole point of owning a bond is that you will get your money back at maturity date.

The point I want to make about bond pricing is that when the Federal Reserve moves interest rates the market price of bonds changes. If the Fed increases interest rates the current value of bonds will go down but the interest payment will remain the same and the bond will return to full value at maturity.

In the current environment we have seen the price of bonds decrease over the last six months. This is normal when interest rates are being increased. Now that the Federal Reserve has said that they are near the end of interest-rate increases it is reasonable to expect that the prices of the bonds we hold will not continue to decrease. I would expect to see prices level out for a while or possibly increase since the pressure is being taken off. Later on in the economic cycle something else will happen and rates will start to change again, most probably down, and the price of bonds will go up. The bottom line is that bond prices change on a daily basis but end back up at 100% on the maturity date and the income is the same everyday you own the bond regardless of the current price.