Perspectives

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Unnecessary Fears and the Resilience of Bond Markets

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Despite continued resilience of the fixed income sector, investor anxiety regarding interest rates remains. However, this fear is not justified by actual bond market behavior; there is a gap between what is *actually* happening and what investors *believe* is happening. If you're an investor with income needs or carry a strategic allocation to fixed income, you probably shouldn't worry about a bursting bond bubble.

In fact, bonds are actually doing quite well so far in 2014. Bond pessimists may be surprised to learn of two key developments:

1. **Taxable Core Fixed Income More than Completely Recovered in the First Half of 2014.** The Barclays Aggregate Bond Index had its best performance in years, earning 3.93 percent. Despite "bond bubble" hype, taxable bonds only lost 2.02 percent during all of 2013. Thus, the return alone so far this year more than fully restores those losses.

2. **Municipal Fixed Income More than Completely Recovered in the First Half of 2014.** The Barclays Municipal Bond Index also had its best performance in years, delivering a 6.00 percent return. Municipals lost only 2.55 percent during all of 2013, meaning municipals have also more than fully recovered.

Sustained increases in the 10-Year U.S. Treasury rate, and the corresponding impact on bond returns, are shown in the table below. The recent "bond bubble" peak was defined at 2.60 percent on July 31, 2013. Since then, this rate had actually increased, with a local peak occurring on December 27, 2013 at 3.02 percent[1]:

Total Return of Barclays Bond Indices During Sustained Interest Rate Increases

Interest Rate Trough	Starting 10-Year Treasury Rate (%)	Interest Rate Peak	Ending 10-Year Treasury Rate	Cycle Length (Years)	10-Year Treasury Interest Rate Rise	Annualized Index Return During Period (%)	
						Barclays Aggregate Bond Index	Barclays Municipal Bond Index
12/30/1976	6.80	9/30/1981	15.84	4.75	132.94%	1.43	N/A[2]
1/13/1983	10.27	5/30/1984	13.99	1.38	36.22%	6.14	7.98
12/4/1986	7.01	10/16/1987	10.23	0.87	45.93%	-2.90	-3.57
9/8/1993	5.23	11/7/1994	8.05	1.16	53.92%	-4.13	-2.65
10/5/1998	4.16	1/20/2000	6.79	1.29	63.22%	-1.40	-1.95
6/13/2003	3.13	5/12/2006	5.19	2.92	65.81%	1.55	2.80
12/18/2008	2.08	1/7/2010	3.85	1.05	85.10%	6.51	16.07
6/1/2012	1.47	12/27/2013	3.02	1.57	105.44%	-0.20	0.14

Past performance is not indicative of future results. Sources: Barclays Live, St. Louis Federal Reserve Economic Database (FRED)

Clearly, increasing interest rates do not necessarily correspond to negative bond returns. Some returns during rising rate periods have been positive. During the recent rate increase, municipals gained while taxable bonds only lost 0.2 percent on an annualized basis. As you can see, the popular belief that fixed income is in dire straits is not an accurate one.

Bonds differ from stocks by staying relatively close to their par values. Average index bond prices were at historical highs in late 2012 through 2013. The average price has dropped from this premium and is closer to par. Bonds are now near their 20-year average prices. As a result, potential capital losses on bonds have been reduced compared to last year, i.e., the "bubble" may already be largely deflated at this point[3]. Consider that room for upside may have actually been freed up.

While 2013 was not a good year for bonds, they play a key role for a portfolio when equities drop. In a bull market, everyone fancies themselves as risk-takers. In a downturn, these same investors may wish they didn't reduce their fixed income positions. Keeping the long-term portfolio objectives in view is paramount. The chart on the following page shows that the range of expected outcomes for bonds is much narrower than for stocks. Even bear markets in bonds are tame when compared to equity bear markets.

The Fed, Monetary Policy and Fiscal Policy

The Federal Reserve has also been a popular target for criticism. However, many cannot grasp the actual makeup and dynamics of the Fed's balance sheet, the unexpected effectiveness of central bankers, and the complex monetary system interaction effects and future interactions.

Not even trained economists can anticipate the long-term effects of this unprecedented monetary policy since, by definition, these actions have never occurred before in history. However, if investors believe that the Fed's actions may negatively impact the economy, it's inconsistent to invest in a portfolio of all equities, since equities should also be negatively impacted. There is no objective way to know if or when bond prices and returns will continue to be negatively impacted in the short term. Nor is it possible to know whether stocks or bonds will ultimately prove more resilient in the intermediate-to-long term. Market timing of bonds due to reports by people who believe they fully understand bond markets is not a prudent approach. It is better to maintain a diversified approach and be ready for anything that might occur.

[1] As of June 30, 2014, this rate had fallen to 2.53 percent.
[2] The Barclays Municipal Index was not incepted until January 1, 1980.
[3] Note that while municipals have a higher premium than taxable bonds, the same pattern is observed.

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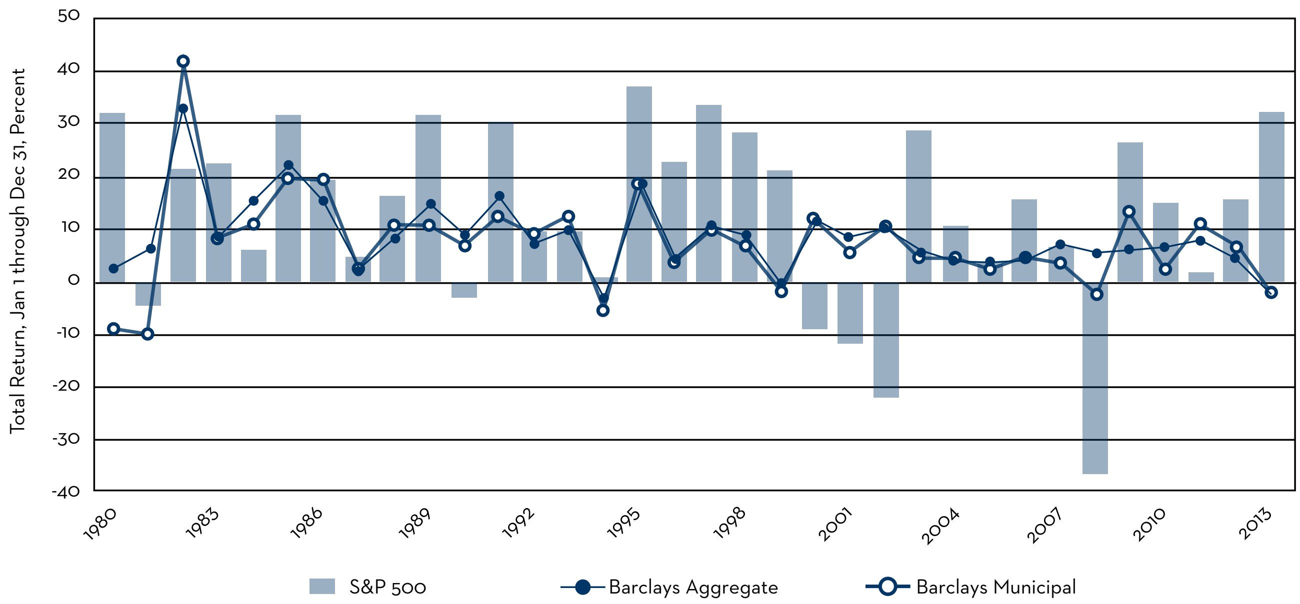
Annual Return of Barclays Indices an S&P 500



Furthermore, critics of the Fed should consider the following:

- **The Fed has kept markets under control.** The Fed has undoubtedly been successful in lessening unfavorable interest rate impacts in the economy thus far. Stocks are at all-time highs and we have already shown that the bond market has barely been affected.
- **Inflationary pressures are just not there.** The supply of money may still be increasing, but at a decreasing rate. Since the rate of turnover for every dollar in the economy is at all-time lows, the net effect is that the decline in turnover has offset the increased money supply, mitigating the inflationary effects.
- **Unemployment continues to improve.** The unemployment rate went from a high of 10 percent in October of 2009 to the most recent rate of 6.3 percent at the end of May 2014. While it may not feel this way in certain segments of the economy, the overall labor market is clearly getting better.
- **The U.S. fiscal situation is improving.** While the overall national debt position of the United States is still relatively unfavorable, while no one was looking, the Federal deficit shrank by more than half since 2010 – all while the domestic economy continued growing.

Beware of Overzealous Anxiety

We believe that the “bond bubble” story is exaggerated and has created anxiety for investors who simply do not understand that the magnitude of harm which may impact their bond positions is, in all probability, minimal at worst. This is especially so when compared to the damage a market downturn could cause to equity positions. Our research suggests the following Conclusions:

- Most of the negative effects of the bond bubble for the period of time which is in the minds of most investors (mid-2012 until end of 2013) have already occurred, and that bond returns in the first half of 2014 have already more than repaired that damage.
- Periods of rising interest rates do not necessarily mean sustained poor bond returns.
- Bond prices are now returning to normal, somewhat reducing potential downward pressure.
- Despite the criticisms, the Fed has done a fairly reasonable job at mitigating unwanted effects in the economy.
- The monetary and fiscal authorities in the U.S. may actually have the flexibility to maintain policies for small but positive growth for at least the next several years.

It is one thing to be suspicious of government and afraid of unprecedented measures, but these fears do not legitimize anxieties in the face of economic evidence to the contrary. None of what the Fed or Congress has done in the last five or six years, in our view, would justify a radical departure from the prescribed 1st Global strategic asset allocations. We believe that adhering to these allocations will produce the best investor outcomes in the long term.

If you have concerns or questions regarding the bond or equity markets, the U.S. economy or other events affecting your portfolio, contact your financial advisor for more information.

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