Fixed Income Market Commentary

June 2013

It Was Inevitable—Treasurys Sell Off

Over a year ago, I wrote that a rise in interest rates was inevitable, just not imminent.

Well, the time may have arrived. We have seen the first wave of that inevitable uptick in interest rates. Where rates go from here is difficult to say, but I suspect they may actually trend down modestly as the higher levels attract buyers who have been patiently waiting for better yields. Now they have them.

The damage to most bonds from rising interest rates and falling prices was fairly light, but May's tumble served up a valuable lesson for investors who continue to believe that safety and security is the preserve of the Treasury market. Treasurys may be credit-risk free because they are guaranteed by the United States government, but they are not without risk to swings in their market value. It's imperative that Treasury investors understand the difference. If they didn't before May, they do now.

As inevitable as the rise in interest rates was, so was the ensuing decline in bond prices—particularly Treasury bond prices. The Barclays Treasury Index fell 1.71%, but Treasury Inflation Protected Securities, or TIPS, took it even harder. With the Barclays TIPS index down 4.36%, you might have thought this was the worst possible month for TIPS on record. Close. It was actually the fourth worst. The worst was in October 2008 when TIPS fell 8.69% during the height of the financial panic.

But a better than 4% decline in a Treasury bond has to awaken even the most somnolescent income investor. And it gives me the opportunity to once again remind you why even Treasury bonds that are geared to help investors deal with inflation can still lose money.

A TIPS bond's principal value is designed to increase by the inflation rate. This makes them very appealing to investors who need to match a future liability (a pension fund manager, for example) or anyone who fears an elevated level of inflation. The problem now is that inflation is actually quite tame, investors are not threatened by it and this contributed to their selloff in May.

As noted, there are worthwhile lessons to be learned from bonds' poor May performance. The big one has to do with yield chasing—an activity that many income investors have engaged in for years now.

Yield chasers have been prospecting at the longest, riskiest end of the yield curve, buying bonds with 20-year and 30-year maturities. I haven't done that because, as I said, I felt a rise in rates was inevitable.

Those who did, however, experienced price losses of almost 9%, for example, on 30-year bonds issued by Apple just over a month ago. I have said repeatedly that discipline is more important than yield for fixed-income investors. It hasn't been easy watching interest rates fall to levels below the lowest I thought they could possibly go, but with each tick down, the risk I saw in bond prices rose dramatically. This is exactly why I have been avoiding the long end of the maturity curve and positioning your portfolios with bonds of a much shorter average life.

Today, all eyes remain on the Federal Reserve. The recent back-up in interest rates can't be what Chairman Bernanke wanted or expected when he intimated to Congress on May 22nd that the Fed might begin "tapering" its bond-buying. I wondered how long it would take the Fed to clarify the language and its position. A few days later, Federal Reserve Bank of Boston President Eric Rosengren gave a speech that calmed the market's nerves a bit, yet Treasury yields remain above 2%.

Barclays Fixed Income Index Total Returns Through 5/31/13

	Duration	May	YTD '13	Return '12	Return '11	Return '10
US T-Bill Index	0.33	0.01%	0.05%	0.12%	0.15%	0.22%
US Treasury Index	5.25	-1.71	-1.02	1.99	9.81	5.87
US TIPS Index	5.62	-4.36	-3.95	6.98	13.56	6.31
US Aggregate Bond Index	5.45	-1.78	-0.91	4.22	7.84	6.54
US Govt / Credit Index	5.83	-1.92	-0.88	4.82	8.74	6.59
US Credit Index {A2}	6.97	-2.36	-0.77	9.39	8.35	8.47
US High Yield Index {B1}	4.14	-0.58	4.15	15.81	4.98	15.12
Caa component	3.47	0.00	7.86	18.34	1.18	16.43
Emerging Market ($$) {BAA3}	6.09	-2.65	-2.15	17.95	6.97	12.84
Municipal Index	7.12	-1.22	0.15	6.78	10.70	2.38
Municipal Index - 5 Year	3.88	-0.59	0.71	2.96	6.93	3.40
Municipal Index - Taxable	10.61	-2.69	0.55	10.86	20.42	7.48

Source: Barclays Capital

First things first though. Tapering—meaning reducing the amount of bonds the Fed is currently buying from $85 billion per month to something less—is not tightening. It would still mean that the central bank was adding stimulus through "quantitative easing," just doing so at a reduced pace.

And the Fed has not yet begun tapering its asset purchases. It's just an option that it has acknowledged may be coming down the road.

The Fed, as always, remains data dependent and has been very transparent and specific about the economic signposts it hopes to see before changing policy. With unemployment still too high and inflation too low, the Fed remains on hold—*status quo*.

While some bond traders have tried to outguess the Fed, leading to the sell-off we saw in late May, I know exactly what I plan on doing: Take advantage of the back-up in rates even if it is only by buying a modest amount of additional bonds. What I won't be doing is extending the average maturity of our portfolios. Rates are still very low and reaching for yield remains a loser's game. Higher interest rates remain inevitable, and may now be a bit more imminent than in months past.

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