Fixed Income Market Commentary

April 2012

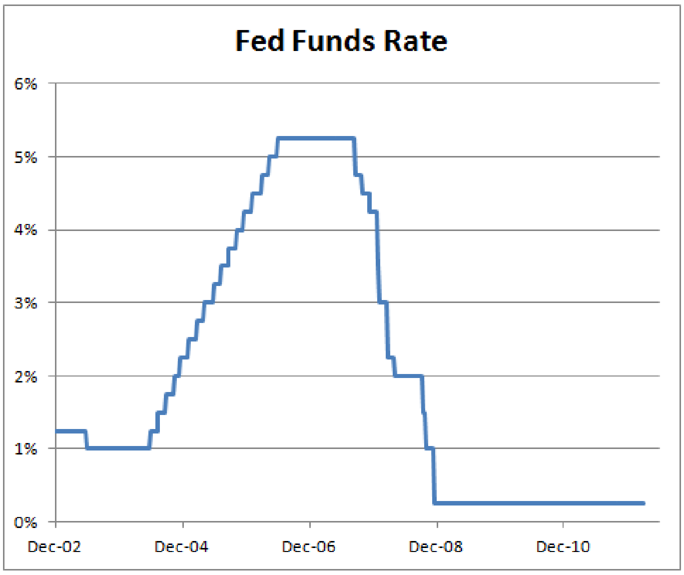
First Quarter Review

"Inevitable does not mean imminent"

Like many who manage bond portfolios for a living, I believe it is only a matter of time before interest rates begin to rise. "An increase is inevitable, but that doesn't mean it is imminent," as a market technician I follow recently quipped. The logic is spot-on consistent with the view here at Adviser Investments that we are in a period of slow economic growth, rather than a period of no economic growth in the U.S. Slow growth will most likely keep a lid on interest rates while the sustained economic growth that we believe is still ahead of us will lead rates higher, eventually.

Interest rates are sitting at near-record lows because the Federal Reserve lowered the benchmark Fed Funds Rate (short-term rates) in response to extreme weakness in the economy after the housing bust and financial crisis of 2008.

The last time the Fed began a concerted effort to push interest rates higher came in the years after the 2001–2002 recession. After leaving short-term rates at 1% for a year, the Fed began slowly and steadily raising rates in June 2004. Over two years, the Fed increased rates 17 times in 25 basis point (0.25%) moves from 1.00% to 5.25%. As you can see in the accompanying chart, after a rapid descent that saw interest rates cut from 5.25% to 0.25% in just 15 months, the Fed has been on hold for more than three years.



While the various stimulus and spending measures enacted over this period have begun to yield a return, there is a lot more that needs to happen before we see a sustained expansion that will prompt the Fed to begin hiking interest rates. The biggest factor is probably the employment picture, which, while improving, still has a lot of ground to make up.

Many bond market investors appear to be on edge, waiting for rates to rise dramatically. I found it noteworthy that when the yield on the 10-year Treasury bond recently moved from 1.82% to 2.37% between early February and mid-March , it was referred to as a "spike." While it's true that the move was dramatic, it was also short-lived. To find a more meaningful spike in interest rates, you need to look back to the end of 2008, when fears of a complete financial meltdown began to ease. At the time, the 10-year Treasury bond's yield moved from 2.05% to just under 4.00% in a six-month span. That was a spike. So, when I hear a move to just 2.37% called a spike, I think otherwise.

In all likelihood, when the time comes for the Fed to tighten, the bond markets will almost certainly move in advance of the event. That is where permanent half-percentage point moves in Treasury bond yields will come from. Until then, I look for interest rates to be range-bound, and even a short-term change of one-half of one percent will simply be part of a general market rotation between buyers and sellers at the institutional level, where large volume trades are often quickly reversed.

Rising interest rates are, as I said, inevitable. Of course, a lot can happen to delay, or even accelerate the start of a meaningfully higher move in rates, including stronger or weaker economic data, global issues that are both economic and political in nature, and, of course, our own domestic politics as well. With this in mind, I have been structuring individual bond portfolios in anticipation of a gradual move higher, but at the same time I am not overdoing it. The portfolios I manage may have a greater weight in bonds on the shorter end of the maturity scale, but I have not ignored the intermediate side either. If the inevitable rise takes longer to materialize, then this positioning will benefit the portfolios overall.

Portfolio structure matters and it is a thoughtful structure that will blunt the impact of an increase in interest rates while continuing to take advantage of the best options available in the markets if rates stay low for a little longer than I expect. I know that interest rates will rise; I just don't believe that a sharp increase is imminent.

First Quarter Review

The data box below shows that riskier bonds outperformed higher quality bonds in the first quarter. Leading the way was the most aggressive sleeve of the **high yield** market, the broader high yield market in general and emerging markets debt. Yield-starved investors are taking on more risk and driving those returns. This move into "risk" assets may be good for some investors, but only if it is consistent with their ability to handle the downside, should sentiment change.

Speculative-grade rated companies brought a record $107 billion in new issues to market in the first quarter as demand soared. Many of the deals are from companies refinancing their high-interest bonds much the same way you would refinance a high-interest-rate home mortgage. Demand for these high-yield bonds remains strong because the default rate continues to be very low, hovering around 2%. The longer-term average annual default rate is around 4%.

In the **Treasury** market it was inflation-linked bonds that once again outperformed nominal Treasury bonds. Investors who are trying to match future liabilities and do not want the uncertainty of inflation risk continue to see value in this market.

In February, the Treasury auctioned off a new 30-year inflation-linked bond. Its coupon was well below last year's 21/8% fixed coupon rate at just 0.75%. Then, in March, they auctioned off a 10-year TIPS bond and demand was so high it sold with a negative yield. Negative yields in the TIPS market are not new, but it still leaves many investors wondering why someone would pay for a negative yield in the first place. The answer, of course, is the expectation that the inflation adjustment to the bond's principal value will more than offset the negative yield over time.

Lastly, the **municipal** bond market continues to put up respectable numbers, even if it did give back some performance in March.

Barclays Fixed Income Index Returns Through 3/31/12

	Duration	Mar	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.32	0.01%	0.01%	0.15%	0.22%	0.37%
US Treasury Index	5.61	-1.00	-1.29	9.81	5.87	-3.57
US TIPS Index	6.18	-1.07	0.86	13.56	6.31	11.41
US Aggregate Bond Index	5.01	-0.55	0.30	7.84	6.54	5.93
US Govt / Credit Index	5.86	-0.86	0.08	8.74	6.59	4.52
US Credit Index {A2}	6.74	-0.79	2.04	8.35	8.47	16.04
US High Yield Index {B1}	4.19	-0.14	5.34	4.98	15.12	58.21
Caa component	3.59	0.76	8.15	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.59	0.35	5.51	6.97	12.84	34.23
Municipal Index	7.62	-0.65	1.75	10.70	2.38	12.91
Municipal Index - 5 Year	3.88	-0.88	0.58	6.93	3.40	7.40

Source: Barclays Capital

I am seeing a new willingness among municipal issuers to entertain the idea of bankruptcy as a way to break or renegotiate overly-generous benefits agreements with public sector employees. Lately, the city of Stockton, CA (population ~ 300,000) has been making headlines in this regard. The city now finds itself in dire financial straits because its city council had, in prior years, agreed to automatic salary increases and other expensive benefits and contracts. Bankruptcy may be the city's only recourse.

However, this is a dangerous path to take. In filing for bankruptcy, an issuer alienates existing bond holders, scares away potential new bond investors and raises its borrowing costs when it eventually emerges from bankruptcy. Because bankruptcy is expensive and tedious to work through, I believe that very few municipalities view it as a smart avenue to take and negotiations may yield better long-term results for all concerned.

Overall, I expect some negative headlines to continue, but at the same time I expect municipal bonds to remain a lower risk, lower volatility asset class and for actual bankruptcies to remain rare, even as the talk of it increases. In this case, bankruptcies may seem imminent, but I don't think they are inevitable.

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