Fixed Income Market Commentary

June 2012

Staying Home, Safe and Sound

Treasury bond yields are too low—as good an indicator as any that something is amiss somewhere in the world. While the financial crisis afflicting the euro zone weighs heavily on bond yields, uncertainty about our domestic economy is also having an impact.

The yield on the benchmark 10-year Treasury recently ventured into uncharted territory, dropping to an intra-day level of 1.43% on June 1st—the day of the disappointing employment report. Adviser Investments' Research Director Jeff DeMaso, scanning *The Wall Street Journal*, sent me this observation: "Even in ancient Babylon (4%), Medieval Europe (6%) and 1800s America (4%), no one was paying 1.6% for 10-year money." (It should go without saying that if they weren't paying 1.6%, they surely had never seen 1.43% either.)

As I wrote last month, "when it comes to an eventual rise in interest rates, inevitable does not mean imminent." Boy was that right.

After a slow but steady rebound from the 2008 recession, recent economic data has shown our economy to be softening, with the employment picture still in need of some serious improvement. And worries are increasing that Europe's sovereign-debt woes won't find an easy fix.

As a result, all paths in the current "risk off" investment market lead to U.S. Treasury bonds. The strength of the U.S. bond market is a reflection of its safety and liquidity. The sting of 2008's stock market decline and the poor performance of even higher quality corporate and municipal bonds remains a painful memory for many investors wary of a repeat—hence the global flight to safety.

At Adviser Investments, we limit our individual bond investments to domestic issuers. Investment-grade-rated U.S. corporations, government agencies and municipalities remain a sea of safety and stability, and since I'm responsible for the oversight of your "safe money," then that is where we will stay.

A recent example: Several weeks ago, I invested in a newly-issued 10-year bond from an "A-" rated Midwest utility. I hesitated when the bond came to market with a sub-3% coupon rate (2.95%). My goal of late has been to find a minimum 3% coupon rate for portfolio construction purposes. But, given the state of the market, I decided to take a five basis point (0.05%) haircut and invest in the bond. After all, I have cash to invest and the longer I hold cash, which yields nothing, the greater the penalty to the client. Now, after the dramatic move lower in Treasury yields, that trade is looking pretty good and I wish I had invested more. This market is making a lot of "bond guys" look good—but as I said, a rise in interest rates is inevitable. I just don't know if it's imminent.

Overall, the municipal bond market remains another zone of safety, but, as always, there are exceptions. One area of concern is tobacco-backed municipal bonds—a class of bonds in which I have ZERO exposure. Tobacco-backed munis are bonds backed by payments from the tobacco giants to the states stemming from a 1998 legal settlement. The payments are subject to revision if smoking rates decline.

Early on I felt that these tobacco munis exhibited too much volatility and lacked sufficient backing. Now, with smoking rates declining, many of these bonds' interest payments could be in jeopardy. Reserve accounts are now being tapped to meet some of these interest payments—a bad sign. As it turns out, smoking is not only bad for your health but it can also be harmful to your investments.

Traditional municipal bonds, however, remain very attractive right now—particularly when compared to Treasurys. They do not trade in lockstep with the Treasury market and while Treasury prices rallied over the past couple of weeks, municipals did not, leaving them increasingly under-valued on a relative basis. In an unusual circumstance, municipal bond yields are currently higher than Treasury yields. Since Treasurys are taxable, their yields should be higher than those on comparable municipal bonds—but they are not. This spells opportunity to me.

Barclays Fixed Income Index Returns Through 5/31/12

	Duration	May	YTD '12	Return '11	Return '10	Return '09
US T-Bill Index	0.34	0.02%	0.03%	0.15%	0.22%	0.37%
US Treasury Index	5.81	1.71	1.86	9.81	5.87	-3.57
US TIPS Index	4.97	1.67	4.62	13.56	6.31	11.41
US Aggregate Bond Index	5.09	0.90	2.33	7.84	6.54	5.93
US Govt / Credit Index	6.03	1.22	2.67	8.74	6.59	4.52
US Credit Index {A2}	6.90	0.68	4.10	8.35	8.47	16.04
US High Yield Index {B1}	4.20	-1.31	5.05	4.98	15.12	58.21
Caa component	3.71	-2.35	6.72	1.18	16.43	90.65
Emerging Market ($$) {BA1}	6.51	-2.68	4.08	6.97	12.84	34.23
Municipal Index	7.30	0.83	3.78	10.70	2.38	12.91
Municipal Index - 5 Year	3.87	0.43	1.81	6.93	3.40	7.40

Source: Barclays Capital

One final word on munis: Significant interest payments and redemptions typically occur during the summer, with July being the biggest month for this activity. Collectively, about $140 billion will be returned to investors as bonds mature or are refinanced—much of this will be reinvested in the marketplace. The challenge is that the forward-looking calendar suggests that only about $120 billion in new issue supply is on tap, meaning there will be a mismatch. Adding to the mismatch is the fact that muni bond funds are taking in about $1 billion per week in new money flows. I expect these factors will contribute to continued demand and support for muni prices at current levels.

While the 30-plus-year-old bond bull market may be on its last legs, particularly when it comes to Treasurys, I believe there is still plenty of fight left in the high-quality corporate and municipal bond markets. Investors flock to Treasurys when they are fearful; that is why Treasurys rallied so hard and why I still see value in corporates and munis. This is where I expect to take advantage of opportunities when I find them. Enjoy the summer.

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