Fixed Income Market Commentary

September 2013

Okay. Now What?

The bond market's number one buyer is still in the game.

The Federal Reserve's Open Market Committee took a pass on slowing (or tapering) its $85 billion per month spending spree and the bond market cheered.

As I write this, the yield on the benchmark 10-year Treasury has dropped from a recent high of 3.00% to 2.62% and prices have risen 3.0%. Those moves are big, but appropriate for the normally staid Treasury market.

I believe the market was oversold, so a snapback in prices and a drop in yields came as no surprise. Many investors sold bonds throughout the summer in false confidence that a September tapering was a given. They were wrong, and upon hearing otherwise the motivation to sell turned into a rush to buy.

The Fed's decision is actually bullish for bonds because it's an affirmation that the slow pace of economic growth and stability continues to be just that—slow. A slow economy, coupled with a very nonthreatening inflation rate is inconsistent with rising interest rates. All bonds benefited once the Fed's resolution was made public.

So, now that we've essentially retraced our steps to where the bond market was trading in early August, I believe investors who haven't already restructured their portfolios to shorten duration as protection from rising interest rates should consider this a second chance. And by the way, these kinds of chances don't come along that often.

Investors who chased long bonds purely for their yields learned a valuable lesson during the summer selloff. The current rebound is welcome, but it's not enough to wipe out the stinging losses suffered at the longest end of the yield curve. Investors holding long-maturity bonds have now seen, firsthand, what happens when there is simply an expectation of tapering—without any actual action. When the Fed does finally act, the performance of long bonds could be in for another hit.

Yes, the selloff created a buying opportunity, but as I've already suggested, stay away from the long end. I know I will. Our investment team remains focused foremost on protecting on the downside, and avoiding long-maturity bonds is one of our basic strategies.

I suspect the bond market could become more volatile in the coming weeks. The debt ceiling, the new federal budget and threats of the U.S. defaulting on its obligations will take turns in leading the news cycle, and it won't be pretty. This will mainly be the reaction to a lot of political posturing between the two parties and nothing more. Any mention of a Treasury default is silly, and far removed from reality.

Barclays Fixed Income Index Total Returns Through 8/31/13						
	Duration	Aug	YTD '13	Return '12	Return '11	Return '10
US T-Bill Index	0.32	0.01%	0.08%	0.12%	0.15%	0.22%
US Treasury Index	5.09	(0.49)	(2.69)	1.99	9.81	5.87
US TIPS Index	7.68	(1.45)	(8.07)	6.98	13.56	6.31
US Aggregate Bond Index	5.55	(0.51)	(2.81)	4.22	7.84	6.54
US Govt / Credit Index	5.63	(0.61)	(3.05)	4.82	8.74	6.59
US Credit Index {A2}	6.65	(0.81)	(3.70)	9.39	8.35	8.47
US High Yield Index {B1}	4.25	(0.61)	2.71	15.81	4.98	15.12
Caa component	3.70	(0.30)	7.81	18.34	1.18	16.43
Emerging Market ($$) {BAA3}	5.70	(1.96)	(7.33)	17.95	6.97	12.84
Municipal Index	8.45	(1.43)	(4.92)	6.78	10.70	2.38
Municipal Index - 5 Year	3.97	(0.70)	(0.98)	2.96	6.93	3.40
Municipal Index - Taxable	10.64	(1.50)	(6.24)	10.86	20.42	7.48
						Source: Barclays Capital

When will the Fed begin to slow its bond purchases? Tapering will begin when the economic data are consistently better and the quality of new jobs improves. The recent deterioration in the "participation rate" in the workforce that Chairman Bernanke referred to in his press conference last week is just the latest stumbling block.

Fed policy is not on autopilot waiting for a magical 7% unemployment rate to appear or for inflation to rise above 2%. So if you hear someone telling you they know precisely what the Fed will do, and when, consider how wrong the talking heads were over the past few months, and focus on the smooth ride and consistent income that a high-quality, short-duration bond portfolio provides.

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