Fixed Income Market Commentary
June 2014

Bonds Surprise

Bond investors have been served some fine returns so far in 2014, and those returns reach across all sectors—from high-quality Treasurys, to always-popular-but-sometimes-maligned munis, to low-quality junk bonds.

After the bond market's 2.0% decline in 2013, expectations for further losses this year were a foregone conclusion. A "great rotation" of cash from bonds into stocks was supposedly baked into the market's cake.

Surprise! Journalists, bloggers and financial pundits of all stripes have been at a loss to explain the reason for the surprisingly strong performance. Let me give you my perspective on why bonds have been strong:

- Rebalancing of institutional portfolios after last year's outsized stock market performance moved money back into bonds.
- Lingering concerns about the strength of the economy continued to make bonds a popular safe-haven as investors seek yield.
- Global central-bank policy means U.S. Treasurys still yield more than many highly rated alternatives

But something I have learned over my career is that the markets will often do the unexpected, and explaining these surprises is not easy.

So where do we stand today? Interest rates remain low across the globe, and the early-June rate cut by the European Central Bank suggests rates aren't headed higher any time soon. The U.S. economy's rebound from a weather-chilled first quarter is underway, but we still don't know how robust that rebound will be if growth is slowing, or moving backwards again in Europe. The stock market continues to surprise to the upside, though our strategists at Adviser Investments believe a 10% to 15% correction could occur at any time, for any reason. If that were to happen, I believe yields on U.S. Treasurys would fall even further in an accelerated flight to quality.

Barclays Fixed Income Index Total Returns Through 5/31/14						
	Duration	May	Return '14	Return '13	Return '12	Return '11
US T-Bill Index	0.33	0.00%	0.03%	0.10%	0.12%	0.15%
US Treasury Index	5.27	0.94	2.86	(2.75)	1.99	9.81
US TIPS Index	7.05	2.12	5.51	(8.61)	6.98	13.56
US Aggregate Bond Index	5.61	1.14	3.87	(2.02)	4.22	7.84
US Govt / Credit Index	5.92	1.13	3.98	(2.35)	4.82	8.74
US Credit Index {A2}	6.98	1.41	5.61	(2.01)	9.39	8.35
US High Yield Index {B1}	4.05	0.92	4.59	7.44	15.81	4.98
Caa component	3.12	0.64	4.46	13.82	18.34	1.18
Emerging Market ($$) {BAA3}	5.94	2.65	6.70	(4.12)	17.95	6.97
Municipal Index	7.16	1.29	5.91	(2.55)	6.78	10.70
Municipal Index - 5 Year	3.83	0.66	2.23	0.81	2.96	6.93
Municipal Index - Taxable	10.63	2.53	10.48	(5.75)	10.86	20.42
						Source: Barclays Capital

Meanwhile, we have enjoyed the bond market's unanticipated, positive returns. We remain in a familiar, low-yield environment, for which our portfolios had already been positioned. We're ready for interest rates to drift higher, but don't anticipate this will happen in the near term.

Remember that just because bond yields are low doesn't mean you can't earn positive returns. If there's a lesson in the investment markets' performance over the past several months, it's the fact that unexpected market environments are precisely why prudent investors like us *need* to stay diversified in our portfolios.

Christopher Keith
Senior Vice President
Fixed Income Manager