Fixed Income Market Commentary
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A New Year Evolution

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Despite concerns that the Federal Reserve will pull the rug out from under the bond market when it begins raising interest rates in 2015, I believe total returns should remain positive for most fixed-income investors because longer-term rates will be relatively stable.

My crystal ball, admittedly a bit hazy, foresees an environment where the yields on long maturity bonds fall as their prices rally at the same time that short-term interest rates rise. In bond market jargon this is referred to as yield curve flattening.

Overall, bond investors should be overjoyed as the Fed starts on the path to a policy where short-term interest rates are greater than zero. That said, I expect the Fed to err on the side of caution and begin with baby steps. Interest-rate hikes in the one-eighth to one-quarter point range should be the norm. All other things equal, I think rate hikes will begin sometime around the middle of the year. This will give the markets a gentle nudge, rather than a shock, validating what I've been expecting and demonstrating that the landscape is indeed changing. Nobody should be caught off guard by such a move, which I believe is precisely what Fed Chair Janet Yellen is hoping for. As I've said before, a return to interest-rate normalization should be construed as a positive, indicating our economy is strong and growing.

Long bonds will not react to the Fed's moves in the same fashion. Inflation and investor expectations for inflation have a much greater influence on long-term yields—and prices. With little inflation to be found, I think bond yields will either stand still or fall a bit as large, institutional investors revisit their outlook on the impact of lower commodity prices, particularly oil, worldwide. Inflation targets everywhere are falling and for good reason. Inflation will remain non-threatening and likely drop further from today's already below-average levels.

When you remove the threat of inflation—the archenemy of bond investors—the dollars that are generally invested in lower volatility assets will find their way into longer maturity bonds. This is what will lead to the drop in bond yields and thus result in positive returns. This is not an outlook that I had a few months ago, but the rapid, and unexpected drop in oil prices has led me to an evolved view. To paraphrase John Maynard Keynes, "When the facts change, I change my mind."