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A Bond Bubble?

By Louis E. Conrad II, CFA

- Bond investors have been the beneficiaries of a 30-year plus bull market (though with some corrections along the way) as interest rates have declined.
- COMPASS expects interest rates to reverse course as the economy improves and the Federal Reserve ultimately halts its bond buying program.
- This reversal in interest rates could spell disaster for conservative investors who have not structured their bond holdings appropriately.

Bond investors have enjoyed more than 30 years of generally declining interest rates. As yields have fallen, bonds have appreciated, leading to a long bull market for bonds. Since the 10-year U.S. Treasury peaked at a yield of 15.8% in 1981, yields fell to a record low of 1.38% in July, 2012 (they were less than 1.7% recently). Given the historically low yields that bonds are presently trading at, some market commentators believe bonds could be subject to a meaningful decline in value. They fear the bursting of a bond "bubble" and argue that bonds should be sold prior to a reversal in interest rates.

Bond Basics

The most basic concept to understand with regard to bonds is that their prices move inversely to interest rates. That is, as interest rates decline, like they have for over 30 years, the value of bonds will increase. Conversely, should interest rates rise, bond prices will fall.

The impact of higher interest rates on the bond market could be meaningful, especially if they were to increase significantly over a short period of time. In such an environment, the value of bonds could unravel, leading to significant losses. For the U.S. bond market overall, a 1% increase in interest rates could mean a 5% decline in bond prices.

It is important to remember that a bond's return has two components: (1) a change in the bond's underlying value, just like a stock, which is usually due to interest rate changes or credit quality changes and (2) interest income. A changing interest rate environment will impact a bond's price, but not the interest income generated by an existing bond (except floating rate notes, which are referenced below).

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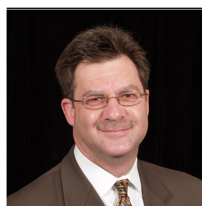

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A Bond Bubble? continued

Quantitative Easing

As a result of the Financial Crisis, the Federal Reserve has instituted monetary programs (commonly referred to as Quantitative Easing, or QE) that have involved the purchase of U.S. Treasury and mortgage-backed securities. The goal has been to prop up bond prices, and thereby lower interest rates, so that the economy and housing market could mend. In that regard, many believe the Fed's policy has been successful as witnessed by the decline in interest rates. The U.S. economy, though hardly booming, has generated growth since the Financial Crisis, whereas the European Union is now back in a recession. Our housing market is also finally healing as evidenced by declining inventories and increasing prices.

While the Fed's QE program has had positive effects on the U.S. economy, it has also led to a tripling of the Fed's balance sheet since the onset of the Financial Crisis. The Fed's bond buying program will need to be curtailed and ultimately reversed. Just as the Fed's bond purchases stimulated economic growth, their curtailment will have the opposite effect. In fact, without the Fed's QE program, many market prognosticators believe the yield on the 10-year U.S. Treasury would be 0.50% - 1.50% higher than the current rate. As the bond purchase program is curtailed, which is expected to occur between late 2013 and 2015, interest rates are expected to rise to more normal, less Fed-induced levels.

Actions to Consider

COMPASS Wealth Management, LLC believes that this is not an all-or-nothing choice. We advocate for allocating some portion of each client's portfolio to bonds, depending on their investment time horizon, risk tolerance, and other factors as a diversification measure irrespective of the market environment. Though we advocate maintaining a bond allocation, we are also mindful of the deleterious effects that rising interest rates can have on bond holdings. Consequently, we suggest the following:

* Avoid long-term bonds as these are most susceptible to harsher price declines in a rising interest rate environment. Favor short- and intermediate-term bonds instead, whose market value will hold up better when rates are rising.

* Diversify into other areas of the bond market, depending on your appetite for risk and market opportunities, such as floating rate notes, high yield bonds, and international debt, including the emerging markets.

Depending on your income tax bracket and the types of investment accounts you have, you may want to consider corporate or municipal bonds, but this is a topic for another time. Whatever types of bonds you invest in, be sure to be cognizant of the impact interest rate changes can have on the value of your bonds and position them according to your individual circumstances and the interest rate environment.

Monthly Market Commentary

Economic data, corporate earnings, and corporate forecasts continued to be a mixed bag even as the S&P 500 rallied past 1,600 in April. Markets reacted favorably when central banks made announcements to address some of the market weaknesses (European bankers reduced their target interest rate and the Fed affirmed that it had no plans to reduce its interventions in the near future). Markets did crash on April 23 in a matter of minutes, albeit briefly and temporarily, when the AP's Twitter account was hacked and sent a fake tweet, causing a swift drop reminiscent of the 2010 flash crash. Overall, Morningstar economists believe that the U.S. economy is neither booming nor busting. Nothing in the numbers would indicate that much has changed when looked at from a year-over-year, averaged basis—the underlying 2% growth rate continues to be largely unchanged.

GDP: First-quarter real GDP in 2013 grew by 2.5%, well below the 3%-plus expectation that many economists had, but still much better compared with an abysmal fourth-quarter growth of 0.4% in 2012. GDP growth was mostly dragged down by continued poor government spending and a larger-than-expected trade deficit. Unfortunately, the worst of the government impact may still be ahead of us, since the first-quarter numbers do not include any impact from the sequester.

Employment: April's total non-farm payroll growth beat expectations, with 165,000 jobs added. More importantly, sharp revisions in the March and February employment numbers saw an impressive net positive revision of 114,000 jobs. Despite all this good news, careful analysis shows more of the same slow and unsatisfying growth, stuck between 1.9% and 2.1% (three-month year-over-year average) for nine consecutive months. The unemployment rate in April edged down slightly to 7.5% from 7.6% the month before.

Housing: On a year-over-year basis, all 20 markets in the Case-Shiller Index saw price appreciation in February, although the growth was not evenly distributed across cities. Phoenix, San Francisco, Las Vegas, and Atlanta all grew by more than 15%, while other cities such as New York, Chicago, and Boston grew by less than 5%. Inventories are still very tight at a time when demand is up because of an improved economy, leading to higher home prices. Higher prices should continue to bring more houses on to the market and bolster consumer confidence. In addition, higher home prices have caused more homeowners to step up their remodeling expenditures, and should also allow more potential employees to move to new cities for employment opportunities.

Manufacturing: According to data from Markit, a worldwide research firm, manufacturing in April declined in the U.S., China, and Europe. The data showed monthly acceleration and improvement through January 2013, after which three months of decline brought it back to where it started in November. Morningstar economists believe that seasonality and a slumping commodities cycle are responsible for the softness worldwide, and not the all-important consumer-demand factor, which drives manufacturing. However, the impact of manufacturing on the macroeconomic picture tends to be strongest in extreme boom-or-bust situations. The U.S. economy is currently doing neither at the moment.

Auto: Auto sales in April dropped modestly to 14.9 million units from 15.25 million units in March 2013, but this was still better than the 14.1 million units from April 2012. Morningstar's auto sector analysts are not overly concerned with the sequential decline as fluctuations are normal, and there are still plenty of reasons to buy a new vehicle, such as low interest rates and a recovering housing market. They continue to maintain full-year sales expectations of 15.2 to 15.5 million units.

Making Up for Retirement Shortfalls

Given the backdrop of economic uncertainty and the rise in both life expectancy and medical costs, prospects look difficult for those facing retirement shortfalls. Fortunately, a financial advisor can show you how pulling these key levers can help your retirement nest egg last.

Work Longer: Working longer is one of the easier solutions for those facing retirement shortfalls, allowing you to contribute to your savings for a few more years.

Reduce Spending During Accumulation Years: One of the best ways to save more is to spend less. Setting explicit goals with a financial advisor, having a clear understanding of your net worth, and carefully tracking expenses are essential to reducing your spending.

Reduce Planned Expenses in Retirement: Your retirement nest egg may last longer if expenses, such as home costs during retirement years, are reduced.

Optimize Your Asset Allocation: As you near retirement, a portfolio that is too conservative can be just as risky as one that is too aggressive. Retirement can be a 30-year prospect, long enough to consider a specific allocation to stocks, which, although they are more volatile, offer higher return potential over time.

Delay Taking Social Security: If you're healthy and expect to live long, waiting until age 70 to receive Social Security benefits can result in a higher payout.

Returns and principal invested in stocks are not guaranteed. Please keep in mind that diversification does not eliminate the risk of experiencing investment losses, and that investing in securities always involves risk of loss. Please consult with a financial professional for advice specific to your situation.

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