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The Interest Rate Outlook

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Is the bond market on the verge of a collapse?

What is Happening to Bonds Markets?

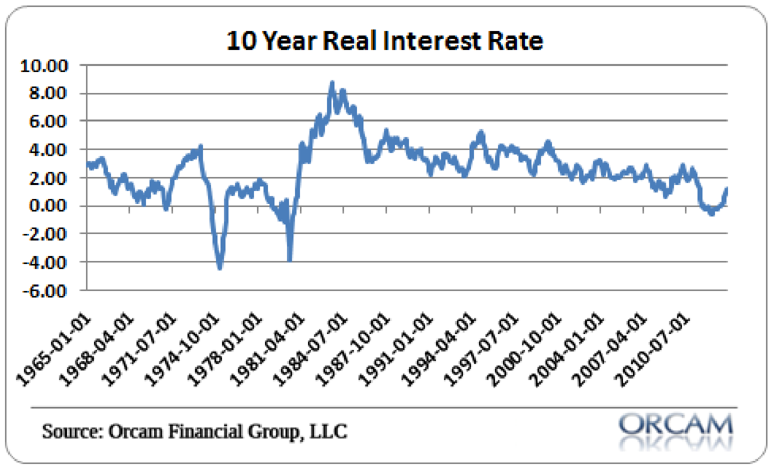
2013 has been a highly unusual year in the fixed income markets. The US government bond market has been particularly unusual. Since 1928 the US government bond market has generated a negative calendar year return just 15 times. Of those 15 occurrences just 3 of them resulted in negative returns of –6.5% or more. This year's 10 year Treasury return of –6.5% year-to-date would mark just the fourth time since 1928 that we've had a bond market bear like this. And things are even worse if you're on the longer end of the curves where the 30 year T-bond is down almost -12% ytd.

We're seeing equity markets perform as you would expect during a year when rates are rising so sharply. That is, investors expect a good economy, Fed tightening and bonds sell-off as a result. That tends to coincide with a more favorable view of equities. But this year isn't entirely driven by a better economic outlook. Yes, the economy has held in there just fine in 2013 (better than most thought), but I wouldn't describe the outlook as improving. I'd describe it more like "muddling".

Now, we should keep things in the proper perspective here before we go throwing all bonds under the bus. While long US government bonds have been slammed the aggregate bond market index (iShares Barclays Aggregate) is down just –3.7%. That's nothing to write home about, but if you're running a traditional 60/40 portfolio with the S&P

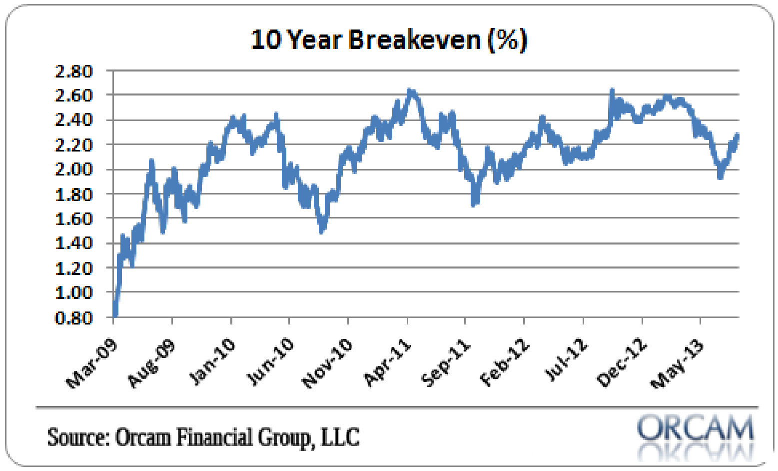
you're up 8.5% ytd with a 2.36 Sharpe Ratio and a 5.6 standard deviation. That's outstanding. Still, the turmoil in bonds has a lot of people on edge and wondering if this is the start of a serious unraveling. I don't see it and I'll explain why.

The 10 year US Treasury bond serves as a benchmark for most of the US bond market. If you can determine the direction of the 10 year the odds are that you'll be able to figure out where the rest of the bond market goes with some variance depending on the specific asset. So I'll focus on 10 years here.



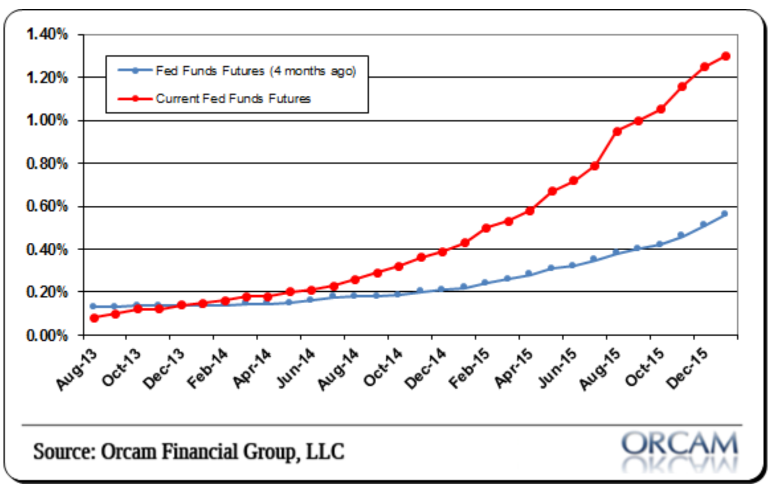
The chart at the right shows the 10 year real interest rate (nominal yield minus the rate of core inflation). Historically, the rate has averaged 2.5%. So bond investors demand about a 2.5% premium to the rate of inflation so they can protect themselves against purchasing power loss. Today the real interest rate is 1.2% which means that investors are willing to forego some real return in exchange for sheer safety. And yes, a big part of the Treasury bond rally as expressed by the lower than average real interest rate, is due to a flight to safety or the persistent fear trade we've seen since the crisis. To me, this correction in 2013 looks like a simple case of bond traders repositioning as they realize the world isn't coming to an end. In other words, if you've been positioned AGAINST the fear trade (through equities primarily) you've done just fine this year. That's why a 60/40 has done just fine.

But where are we headed now? Will a balanced portfolio continue to perform well? Will the flight to safety return? Or will the bond debacle continue? I think this recent move in bonds is largely driven by fears surrounding the Fed and the "tapering". For some reason, this is being viewed as a form of tightening. As if a reduction in bond purchases from $85B to $65 is all that meaningful to begin with. But more importantly, this is nothing like an actual tightening. By far, the more important move will be an *actual* rate increase. And I think the bond market is still getting this one wrong.



First of all, the 10 year break-even rate which shows us future expected inflation in bond markets has actually fallen since the year started. That means that fixed income traders aren't actually worried about the smaller than normal real interest rate. They still expect inflation to remain low. And I think that's the right view. So this move is all about something else. Clearly, it's repositioning due to worries over Fed policy.

But if we look at the current Fed Funds Futures curve we can see just how unrealistic these worries are. The Fed Funds Futures curve doesn't price in a rate hike until early 2015! That means the bond market expects "tapering" to linger into a rate hike for the remainder of 2013 and **all** of 2014. I don't know about you, but I don't see bonds moving lower in a straight line for the next 18 months. In fact, if that happened, it would be the first time US government bonds have ever generated 3 consecutive years of negative nominal returns. In other words, you have to be willing to make a huge bet that this is a big case of "it's different" this time.



Personally, I don't buy into that story and while 2013 hasn't been very friendly to fixed income traders I would expect future returns to be much more stable. And given the massive run in equities, despite my continued bullish core position, I think the fixed income piece is going to serve as a potentially important offsetting component in the coming years.

In short, I don't buy into the high inflation story or the theory that the bond bull market is dead. The much more likely overall story is one of continued muddling economic growth with downside risks and low inflation. As I've mentioned in previous notes I actually think we're closer to recession than economic blast-off and that means the Fed is actually closer to an easing phase than a tightening phase. Remember, "taper" doesn't mean no printing. It just means less printing so let's keep our wits about us and not fall into the trap of panicking like some other investors appear to be doing. The macro picture doesn't rhyme with the micro picture in fixed income markets at present and that's being largely driven by irrational Fed interpretation.

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