BULL AND BEAR BULLETIN

Dissecting the Change in Interest Rates:

Interest rates have experienced a sizeable change since the Federal Reserve announced in December that it would increase its bond purchasing activity to $85 billion per month. Is the increase in interest rates simply a "buy the rumor, sell the news" approach to the Federal Reserve's quantitative easing or is the move just the beginning of the end of a low interest rate environment?

Before discussing the long-term projections for interest rates, several other factors have influenced investors' appetite for bonds in the past two months other than the recent expansion in bond purchases by Ben Bernanke and Company. Just weeks after the additional quantitative easing was announced, we heard the Federal Reserve's idea of how it would reverse its bond purchasing activity, which signaled to some investors that the Federal Reserve may end its easing program earlier than expected. We also witnessed one of the strongest starts in the past 20 years of the stock market, which attracted money away from bonds and towards the stock market (Chart 1). While on their own, neither news item is likely to severely impact the bond market and corresponding interest rates, they could put in motion enough volatility to force investors to reassess their bond holdings.

As we have discussed in past articles and in client meetings, bond prices move in the opposite direction of interest rate yields. While overall interest rates remain at extremely low levels, the recent shift in rate direction has had an impact on bond returns. The Citigroup Corporate Bond Index fell 0.96% in January and the Citigroup Treasury 1-30 Year Treasury Index declined 0.88%. With most bond investors accustom to double-digit returns on an annual basis on the back of unprecedented interest rate intervention by the Federal Reserve, a near 1% decline in returns versus a 5% gain in the S&P 500 may have investors contemplating the "risk/reward" of the bond market.

Traditionally, interest rates have fluctuated based on the bond market's expectation of economic strength. When the economy was expected to expand, market participants would sell their bonds with the belief that the Federal Reserve would increase interest rates to fight growth associated inflation. When the economy was projected to slow or decline, bond investors would purchase bonds in anticipation of interest rate reductions by the Federal Reserve. Unfortunately, today's bond market has a single buyer in the form of the Federal Reserve that accounts for a majority of any new bond activity. This uncharted influence distorts the historical trends and market action that many bond investors have come to rely on to shape their investment thesis, especially in the short to intermediate term bond maturities, where the Federal Reserve is making the majority of its asset purchases.

By recently linking their bond purchasing activity to unemployment and ultimately to economic growth, the Federal Reserve has attempted to provide bond investors with a roadmap to assess when they will ultimately increase interest rates. Investors' diminished appetite for further bond market exposure indicates that they either believe that the Federal Reserve will be unable to follow through on its promise to keep interest rates low through at least 2015 or that the economy is going to improve faster than the Federal Reserve has forecasted.

It is our belief that the increase in interest rate yields has less to do with the Federal Reserve's ability to facilitate a continuation of a low interest rate environment and is more the result of a change in investor sentiment. With the bond market rewarding investors with annual returns exceeding 10% over the past 5 years and yields declining more than 50% over that same

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time period, investors may be facing a dilemma where they could see diminishing marginal returns at greater levels of risk (Chart 2). While the U.S. economy has been lackluster this economic cycle, there are signs that the housing market and personal spending may be improving. With consumers in a position to spend and the housing market no longer acting as an anchor to economic growth, investors are likely to assess a better "risk/reward" relationship in the stock market versus the bond market.

This rationalization may take several forms, including the fact that investors have to purchase Treasury bonds maturing in more than 10 years just to earn a yield greater than inflation. Some investors may view the 2.0% dividend yield on the S&P 500 Index a better value than the 1.95% yield on the 10-year U.S. Treasury, especially when adjusted for further potential price appreciation. Other investors may just recognize that the more interest rates approach the 0.0% boundary, the less upside potential they may earn and the more risk they may ultimately face.

While we do ultimately expect an increase in interest rates going forward in the current economic cycle, we don't expect a rapid jump in yields as long as the Federal Reserve remains committed to its $85 billion in asset purchases each month. We also expect the greatest amount of volatility among interest rates to occur in the 20-30 year range, where there is less intervention by the Federal Reserve and where investors face the greatest amount of sensitivity to interest rate changes.

In an effort to reduce our clients' risk to the declining "risk/reward" relationship in the bond market, we have elected to be more selective in our bond purchases or, depending on each client's personal objectives, reduce their fixed income exposure. For those investors that still require an income stream from their investments, we are making an effort either to utilize dividend paying stocks or to focus on bonds with shorter maturities to reduce interest rate risks.

While investors continue to assess the success of the Federal Reserve's quantitative easing measures and the change in the "risk/reward" relationship within the bond market, perhaps the most intriguing question is where interest rates may go at the end of the current economic cycle. Will investors allow the Federal Reserve to have even greater influence on the bond market in a recession or will they ultimately revolt against the size of the Federal Reserve's balance sheet and manipulation, which already stands at $3 trillion, and elect to seek out alternative investments (Chart 3)? So, as investors currently evaluate their feelings towards bonds, the bigger test may occur when least expected.

Chart 1

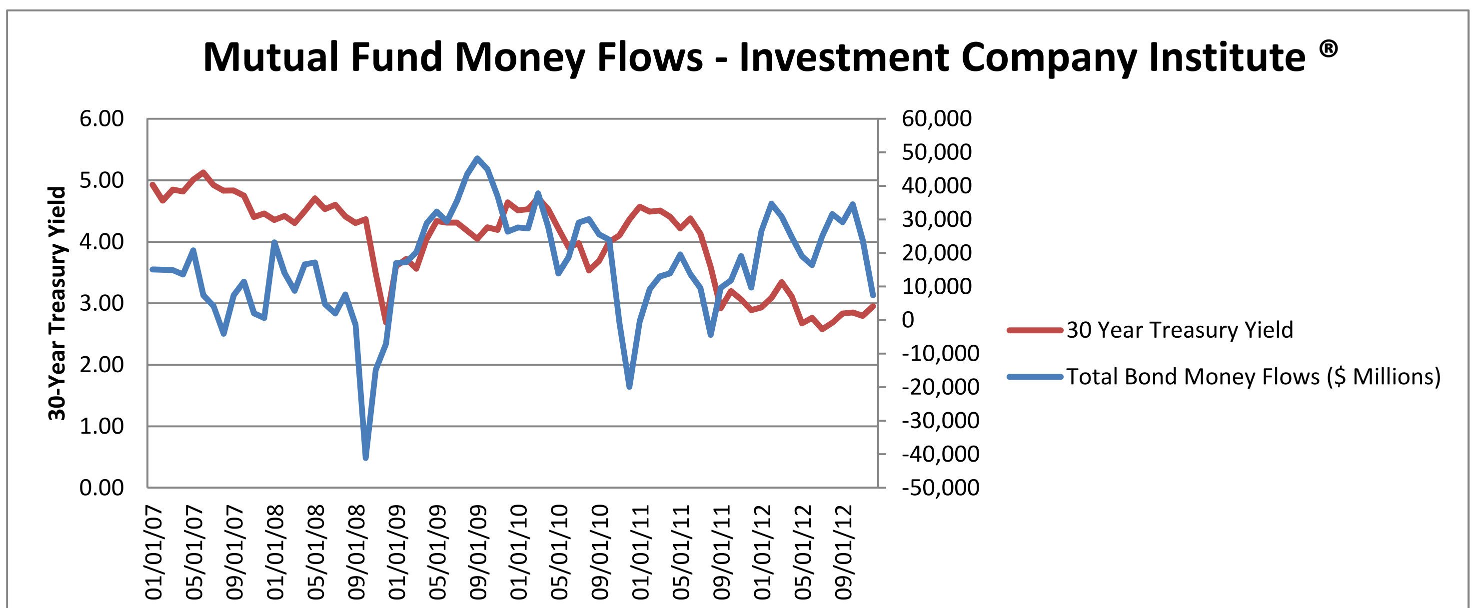

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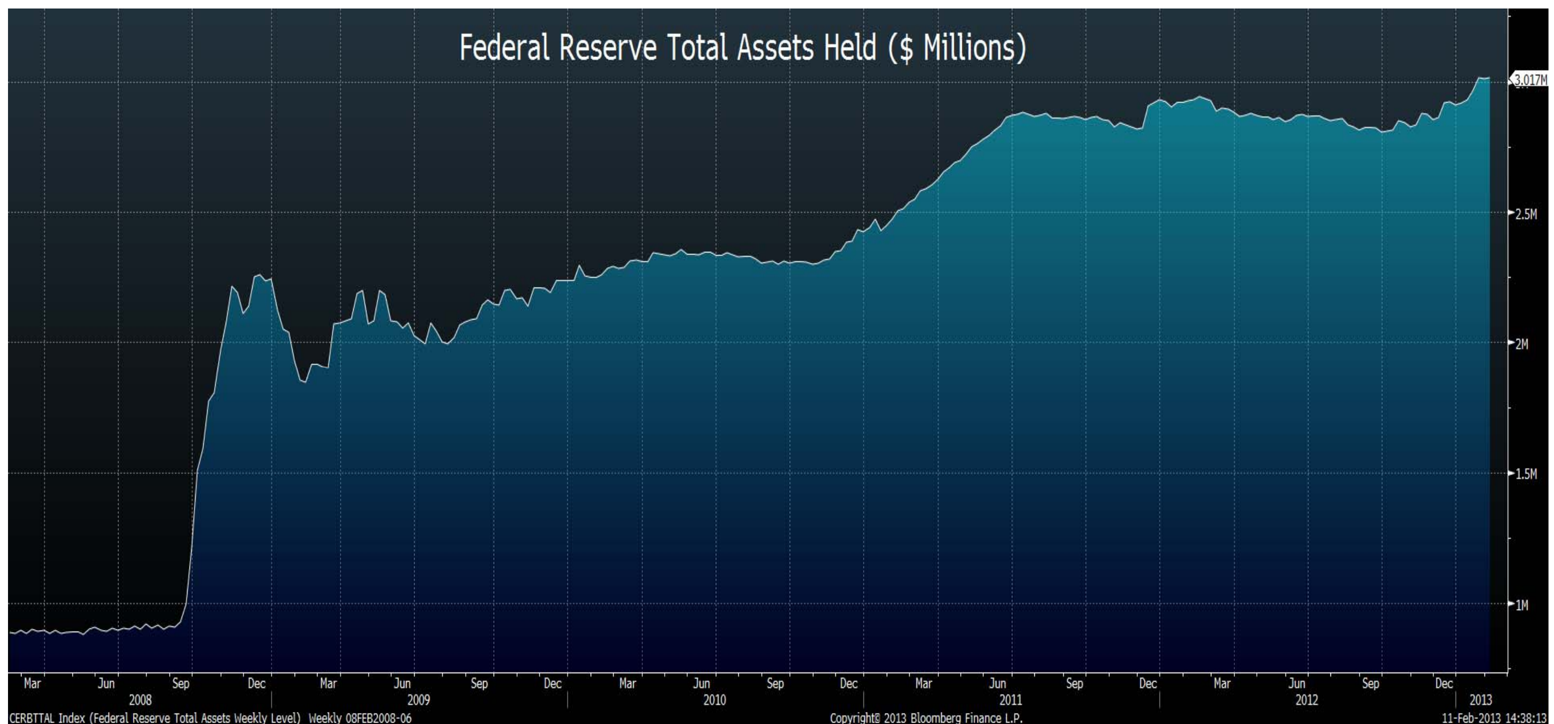
Chart 2

Chart 3



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