



## The End of the Bond Bull Market

*"Before beginning a hunt, it is wise to ask someone what you are looking for before you begin looking for it." — Pooh's Little Instruction Book*

### Summary

- The more than 30-year run in U.S. Treasury bonds, and respective fall in yields, has finally come to an end.
- Over the next decade, we expect that gradually rising interest rates will lead to sub-par bond market returns.
- Even traditionally "safe" fixed-income investments can produce near-term losses in a rising-rate environment.
- Investors should be selective with their exposure to fixed-income securities and should explore alternative means for maintaining the cash flow generated by their investment portfolio.

### Know What You are Seeking

As a father of three, I have the pleasure of reading many children's stories. Occasionally, and often when least expected, this exercise provides kernels of wisdom not typically found in adult reading. Such an experience occurred recently while reading A.A. Milne's classic *Winnie the Pooh*. Although it is not my regular practice to subject readers of *Monthly Insights* to wisdom imparted by a fictional bear, the sentiment of the quote above captures the spirit of this essay.

The key to Pooh Bear's musing is its simplicity – it is important to know exactly what you are seeking. Despite the obviousness of the instruction, I find that investors, instead of focusing on future investment returns, are easily distracted by an investment's recent results. However, recent results often look their best right before a reversal in performance occurs.

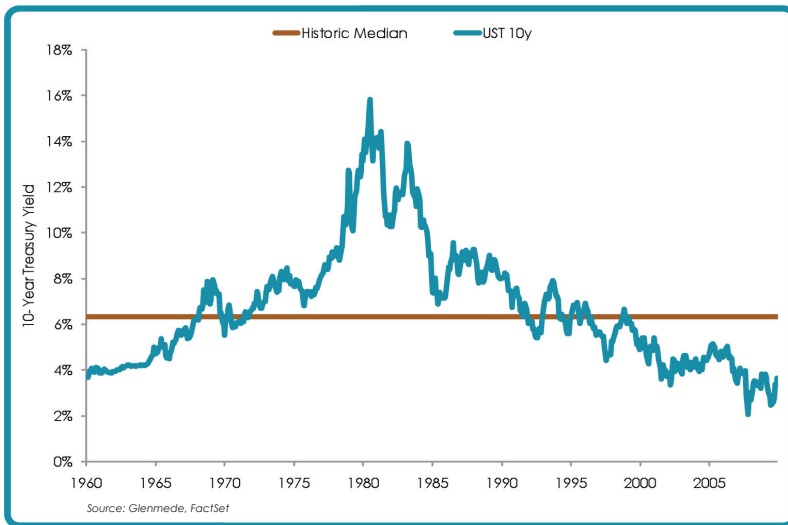
### A Simple Observation: Treasury Yields Near a 30-Year Low

I find this to be particularly relevant with current perceptions of certain fixed-income securities where investors have been generously rewarded the past few years. In 2010, a Treasury bond holder would have seen a return of 8%, well in excess of the coupon, as interest rates fell and bond prices rose. Over the last five years, Treasury bonds have outpaced equities with an annualized return of 5.4%, compared to 0.2% for the S&P 500. Over the last decade, Treasury bonds have posted a 5.3% return versus the S&P 500's 1.0% return.

It is easy to understand how these returns could have influenced people's expectations; however, it is important to step back and look at the bigger picture. Future returns should be the focus and we should not presume a continuation of past performance.

Fixed-income returns have two primary components: yield and price fluctuation. The most predictable of these components is the yield — the longer the holding period, the more dominant it is a driver of returns. If you purchase a bond and hold it until maturity, your return will equal the yield-to-maturity at purchase barring a default.<sup>1</sup> Unfortunately, as of January 31st, 2011, the yield on the 10-year Treasury bond was 3.6%, placing it in the bottom decile of observations over the last 50 years. These yields do not provide a compelling backdrop for prospective fixed-income returns. If we assume interest rates

## 10-Year Treasury Yield Still Near 50-Year Lows



remain unchanged, these low yields will be sub-par to historic performance measurements.

## Interest Rate Changes and Returns

While a bond's long-term return is predictable, near-term returns can fluctuate substantially with interest rate changes. Having experienced a period of falling rates, many investors have become spoiled by the positive outcome of price fluctuations. Unfortunately, price fluctuations are a double-edged sword. Whereas the past few decades of falling rates have provided a nice boost for bond investors, rising rates will now likely produce the opposite result. In fact,

until recently, many investors did not recognize that even "safe" Treasury securities can actually produce losses if rates rise quickly enough.

Below is a table of 12-month returns on Treasury bonds if there were a 1% rise in interest rates:

	Coupon		1% Increase in Rates Over 12 Mo.	
	01/03/94	02/11/11	Total Return on 01/03/94	Total Return on 02/11/11
<b>5-Year Treasury</b>	5.30%	2.26%	2.02%	0.12%
<b>10-Year Treasury</b>	6.01%	3.73%	-1.44%	-2.44%
<b>30-Year Treasury</b>	6.68%	4.71%	-4.75%	-9.26%

Source: Glenmede, Bloomberg

This example illustrates how the current coupon yield on the 10-year and 30-year Treasury would be overwhelmed by the near-term price decline associated with a 1% rise in interest rates. When compared to the rising rate environment of the mid-90s, this effect is more pronounced today due to unusually low Treasury bond rates.

<sup>1</sup> Yield-to-maturity is not the same as the coupon yield; coupon yield is the yield due to actual coupon payments from the bond, while yield-to-maturity includes both coupon payments and an amortization over the life of the bond of the current price discount or premium from par value.

## Interest Rates, Inflation and Changes in Federal Reserve Policy

A primary determinant of interest rates is the market's estimate of future inflation. By comparing the difference in coupon yield between Treasury bonds and Treasury Inflation-Protected Securities (TIPS) of the same maturity, we can measure the financial market's estimate of future inflation.<sup>2</sup>

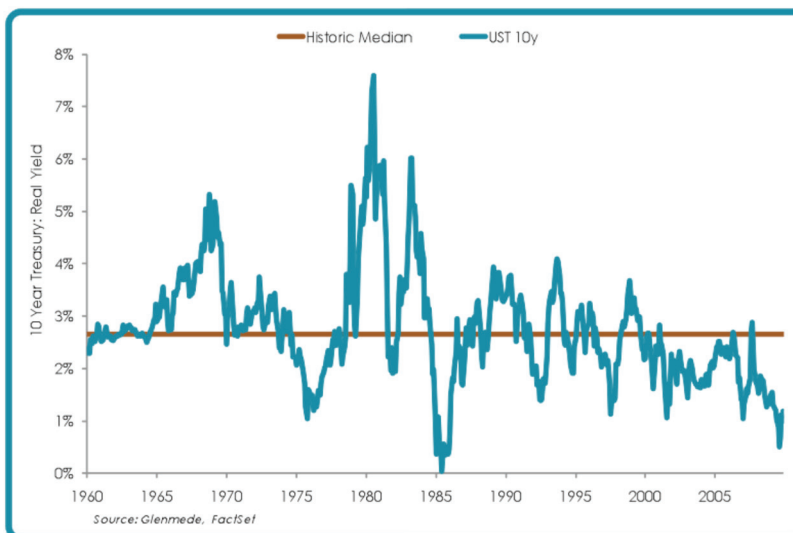
### Inflation Expectations<sup>3</sup>: Back to 2004-2008 Levels



The market, apparently, is no longer worried about deflation. Instead, inflation is expected to return to more normal levels, which are also roughly in line with what the Federal Reserve considers acceptable.

Of course, inflation is not the entire story. Interest rates can also be influenced as demand for fixed-income products fluctuates due to perceived changes in credit risk, investor demand for protection from volatility and/or Federal Reserve action. The real yield of a fixed-income security is the yield in excess of expected future inflation; essentially, this is the end result of all of these non-inflation related factors.

### Real Yields<sup>4</sup> Also Near 30-Year Lows



The graph to the left shows an estimate of the current and historical real yield on the 10-year Treasury. You may notice that real yields are well below the historical median. This should not be surprising, given the Federal Reserve's renewed quantitative easing program and the market turmoil of the past few years which has driven investors to seek protection. However, it does raise the question of whether this trend has gone too far. First, the Federal Reserve is unlikely to sustain its purchasing spree much longer. Second, investor demand for protection appears to be waning. Lastly, although the credit risk of the U.S. government is

normally considered *de minimis*, mounting debt and continued deficits have driven some to begin questioning our nation's AAA rating.

<sup>2</sup> The coupon payment on a Treasury Inflation-Protected Security (TIPS) fluctuates as a result of changes in the underlying principal of the bond, which is adjusted in relation to the Consumer Price Index (CPI). A constant coupon rate, determined at the time of the bond's issuance, is applied to this adjusted principal value to produce the variable coupon payment.

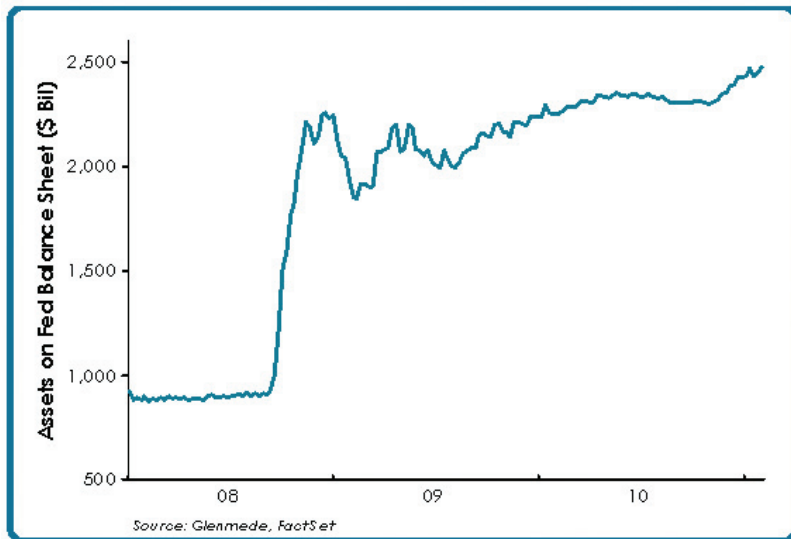
<sup>3</sup> Inflation expectations implied by the difference in coupon yield between 10-year Treasury bonds and 10-year TIPS.

<sup>4</sup> Real yield based on the difference between the 10-year Treasury bond yield and the average inflation over the previous 10 years, according to the consumer price index (CPI) prior to 2004. Real yield based on the coupon yield of TIPS after 2004.

## The Bond Bull Market: Ending with a Whimper

As a result, it is hard not to foresee a rising rate environment. Interest rates have recently hit multi-decade lows, inflation expectations are beginning to rise and the factors suppressing the real yield on Treasuries are likely to lessen in strength. A reversion to more normal levels of inflation expectations (2.5-3.0%) and real interest rates (also 2.5-3.0%) would result in the 10-year Treasury reaching a yield of 5.0-6.0%.

## Fed Balance Sheet Approaches \$2.5 trillion



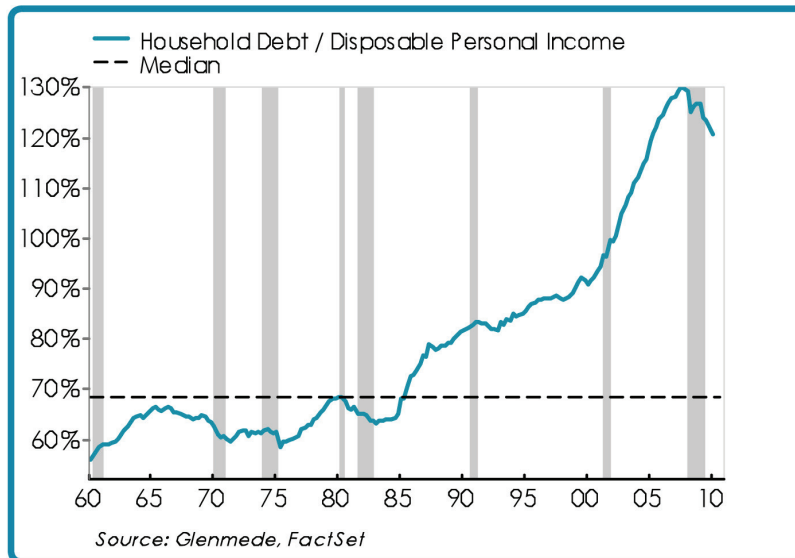
But, how fast is the rising-rate environment likely to occur? In considering the unprecedented sums the Federal Reserve and other central banks have pumped into the system over the past years, many investors fear inflation is around the corner and that the central banks will be unable to contain it in time.

The Federal Reserve has dramatically increased the size of its balance sheet with purchases of mortgage-backed and Treasury

securities, yet this has not caused a surge in the flow of money to businesses and consumers. Lending, while beginning to show some signs of recovery, remains depressed relative to historical levels. The funds created by the Federal Reserve's balance sheet expansion sit idle on bank balance sheets. Stricter capital standards combined with a lack of borrower demand, as a result of the recession, have caused an unwillingness to lend on the part of these financial institutions.

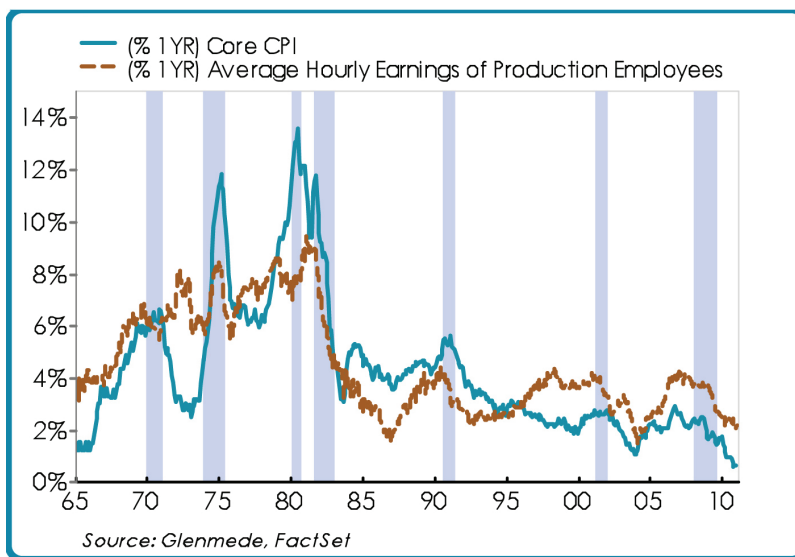
This leads us to our expectation that the bond bull market will end more with a whimper than a bang. Consumers, having allowed their debts to accumulate to 130% of their disposable income, have a long way to go before they return to fiscally responsible levels. The historical median debt-to-disposable-income ratio is close to 70%, which would require an additional 40%-plus reduction of outstanding debt. Whether consumers repay existing debt or default does not matter; either way, debt reduction acts as an offset to the release of excess reserves. In fact, we believe this was the Federal Reserve's intention. By significantly increasing the money supply, the Federal Reserve attempted to stem the deflationary effects caused by the deleveraging of American consumers.

## Outstanding Consumer Debt Still Significantly Above Historical Levels



Furthering the argument against rampant inflation is the current plight of the American labor force. Unemployment remains at an unacceptably high 9% and jobless claims are just starting to return to more normal levels. In light of this overcapacity in the labor force, wages are not expected to rise rapidly in the near future. Inflation, nearly inextricably linked to wage growth, will have a hard time rising quickly as well. While the excess money supply is likely to cause price surges where capacity and supplies are thin, such as agriculture and other commodities, we continue to believe that overall inflation will remain in check. It is for this reason, and the reasons listed previously, that we expect the bond bull market to end more with a whimper than a bang. Rates are unlikely to immediately shoot upward, although there is arguably some risk in this direction.

## Inflation – Hard to Come by without Stronger Wage Growth



## Investment Strategy

This discussion, in a Winnie-the-Pooh-like obviousness, lays out the prospects for an environment of rising interest rates and diminished bond returns. For many, if their portfolio includes a significant allocation to these fixed-income securities, this outlook may cause uneasiness. However, this is not a situation that

has to overwhelm investors. We've included a handful of the obvious and not-so-obvious suggestions for portfolio allocations in this environment below:

- 1. Underweight overvalued “safe” fixed income:** Winnie-the-Pooh himself may have come to this conclusion had he been schooled in the art of fixed-income investing.
- 2. Emphasize better yield opportunities within fixed income:** While all fixed-income securities currently provide yields that are low by historical standards, opportunities remain for relative yield enhancement. Municipal securities continue to provide yields in excess of Treasuries, despite their tax-favored status. However, security selection within this sector is very

important given state and municipal budget issues. For tax-exempt accounts, we continue to see opportunities in corporate debt, both investment grade and the highest quality non-investment grade, as well as in select international sovereign-debt issues.

- 3. Utilize equities to deliver cash flow:** Equities are not as overvalued as fixed income and will likely continue to outperform bonds. Assuming there is flexibility, investors should consider a total-return approach, supplementing income with capital gains realizations as equities rise. Investors that do not have this flexibility, whether due to account distribution definitions or personal preference for income, should consider modifying their equity allocation towards higher dividend stocks. Due to the large range of payout structures within equities, many investors can enhance the yield of their portfolio with little or no impact to the portfolio's total return potential.
- 4. Enhance returns and minimize risk with option-based strategies:** An additional recommendation that we have mentioned before is to utilize what we refer to as a secured options strategy. In such strategies, the investor sells a call against an equity portfolio, preferably the equity index upon which the option is based. The investor relinquishes some of the more distant appreciation in return for the premium collected each month. Given the current miniscule yields on many fixed-income investments and the reasonably large premiums collected from the option sales, we find this a compelling alternative that can enhance and stabilize portfolio returns.

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