Rochester Financial Services

Fee-Only• Financial Management Services

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Dow Jones	S&P 500	NASDAQ	Russell 2000	10 yr Treas	Earnings Yield (S&P)	Gold	Crude Oil
14,932	1,614	3,433	989	2.47%	6.82%	$1,243	$99.60

Investment Strategy Report

Interest Rate Spike Hurts Bonds For a Second Month. Is The Worst Over?

For the last several years, bond funds have been a winning investment for us. They have provided equity-like returns with only a fraction of the risk. That trend continued into 2013 and lasted until May. During that month, interest rates bottomed, with the 10 year Treasury hitting a yield of 1.64%. Since then, we have seen a steady rise in rates, with the 10 year yield hitting a peak of 2.67% last week. A one hundred basis point rise in interest rates is a huge move, especially beginning from such a low point.

Much of that rise was due to investor fear that the Federal Reserve would begin reducing its monetary stimulus program. The Fed is currently buying $85 billion of government securities a month. This "artificial" demand for these bonds has kept their prices high and their yields low. Investor fear started in May and then surged higher on June 18th and 19th when the Fed announced at the conclusion of their FOMC meeting that they may reduce their bond buying later this year rather than in 2014. As is often the case, investors panicked and sold off not only government securities but all types of bonds. For our portfolios, both our traditional and non-traditional bond funds suffered losses of about 2%. While not a huge move, it was very unsettling for me to see conservative investments that normally would not move more than about 0.1% per day, experience losses of 0.5% and higher on days of heavy selling.

This presents a dilemma for me in regards to the management of my clients' portfolios. If bonds can no longer be counted on to provide a conservative return for risk averse clients, then what strategy can we employ to achieve that? The real question is whether the losses sustained in bonds will continue for the foreseeable future, as interest rates continue to rise and investors continue to dump bonds. The good news is that it appears that interest rates peaked last week at that 2.67% level. They have since reversed lower, ending today at 2.47%. This has led to some significant gains in bonds for the first time since May. The reversal in bond yields coincided with a rebound in the stock market, as the Fed-induced market sell-off that began June 19th appears also to have ended last week. So are the stock and bond markets on clear sailing mode now or is this just a pause before the declines continue?

I have spent the last few weeks listening to what the best bond fund managers in the country have been saying about the recent bond sell-off. I have participated in at least 3 webinars given by Jeff Gundlach of DoubleLine. His general thesis is that while everyone has their eyes on the Federal Reserve, the key to the direction of interest rates is to determine how much inflation we should expect. The recent rise in interest rates and sell-off in bonds had nothing to do with inflation and everything to do with indiscriminate selling, he contends. And when investors resume a more rational approach to fixed income investing, they will realize that inflation is very low and therefore interest rates need to come down. Most government indexes on inflation measure it at 1 to 1.5%. Commodity prices have been falling. Global growth from China to Brazil has been slowing. The risks remain to the downside and deflation is more of a concern than inflation. With 30 year fixed mortgage rates now at 4.5%, up from 3.5% just 2 months ago, he feels that if rates moved any higher, they would pose a risk to the recovering housing industry. And the Fed can't allow that to happen. He expects to see the 10 year yield heading back towards 2% and even as low as 1.70%.

Dan Fuss of Loomis Sayles agrees that we witnessed a technical correction in bonds, with the backup in interest rates overdone by at least 40 basis points. Bill Gross of PIMCO also feels that the 10 year Treasury should be yielding no more than 2.20%. Based on the forecasts of these bond gurus and the reversal that occurred in rates since last week, I do feel more comfortable that our remaining bond funds will continue to contribute to our portfolios' performance, on both a risk and reward basis. However, I do encourage you to keep in contact with me to make sure that you are comfortable with your current portfolio allocations. *Jeff Feldman*

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