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
15,041	1,623	3,424	979	2.08%	6.78%	$1,412	$94.69

Investment Strategy Report

Bonds Finally Crack as Rates Spike Higher. Stocks Suffer a Pull Back

While the "Sell in May" maxim didn't pan out for stock investors last month, bond investors would have done well to heed that advice. The action in the bond markets took center stage as bonds suffered their worst losses in 9 years last month. As examples, the Barclay's Long Term Treasury Index (TLT) lost 7.7% in May while the Vanguard Inflation Protected bond fund (VIPSX) lost 4.3%. And these losses were in so called conservative bond funds which are supposed to offer a safer alternative to stock investing. While we were all anticipating that interest rates would have to rise eventually, the speed and magnitude of last month's rise was especially surprising. The 10 year Treasury began the month with a yield of 1.64% and ended the month with a yield of 2.16%. An increase of 52 basis points when rates were so low to begin with was indeed a shock to the system.

I especially wanted to begin this letter addressing the situation in the bond markets because our bond fund investments have been a key component to our investment strategy for several years now. These funds had continued to gradually move higher even in the face of volatility in the equity markets. They served us well to provide solid returns with only a minimum amount of risk. As rates began to move higher last month, I pointed out in my last letter that even though our traditional bond funds had lost a little ground, our moderate or non-traditional funds were doing fine, therefore balancing out the performance. However, before the month was over, all fixed income investments got hit. Fortunately, the average loss for my top 4 bond funds last month was "only" 0.6%. While this could have been quite a bit worse, I still see this as a break in trend, at least temporarily. I am not willing to absorb sizeable losses in these investments so I will be keeping a close eye on their performance.

When I want to get an expert opinion on the state of the bond markets, I turn to the top bond fund manager in the country, Jeff Gundlach of Doubleline funds. I attended a webinar that he presented yesterday and also listened to his appearance on CNBC. For the most part, he was upbeat on the prospects for fixed income. His initial thesis was that since we are seeing declining world GDP growth, interest rates will not be experiencing much upward pressure. With the current 10 year yield at 2.08%, he doesn't see rates moving any higher than 2.30 to 2.35% as the upper limit of the range. He thinks that bonds are a buy right now and expects that the 10 year Treasury yield will be back below 2% some time during the next few months.

Another fear that bond investors have is that the Federal Reserve will soon begin to taper their bond buying program, which would cause bonds to lose value and interest rates to climb. However, Gundlach believes that the Fed is not willing to risk a rise in interest rates, which would have a stifling effect on the housing market and put our economic recovery in danger. Therefore, they will do whatever it takes, e.g., resuming their bond buying, to insure that that doesn't happen.

Gundlach also addressed fears that at some point, inflation will again become a threat. He stated that he sees no signs of inflation any time soon. As an example, he pointed out that commodity prices have been declining throughout the year, an indication that deflation right now is more of a threat than inflation.

I do want to spend a little time discussing the stock market and the risks that I foresee for our investments. After surging for 6 months with only minor pull backs, the S&P 500 peaked on May 21 at 1669. As of last night's close of 1609, the index suffered a decline of about 3.5%. While only a minor correction, investors are already sporting a "run for the hills" mentality. Part of this is due to the recent plunge in the Japanese stock market. Other concerns are 1) a fear that the Fed will remove its stimulus program and 2) doubts about the US jobs picture. An overall concern is that after running up so high, investors can't believe that stocks can continue moving higher. Depending on which analyst you listen to, the day to day economic data can be seen as positive or negative. Today we observed a nice stock market turn around, with the Dow recovering from a 116 point sell off to finish up 80 points. At least for now, it seems that the uptrend is in tact. *Jeff Feldman*

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