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
17,849	2,093	5,068	1,261	2.40%	5.97%	$1,171	$58.93

Investment Strategy Report

Is The Day of Reckoning Here for Bonds?

The yields on US bonds are taking their cue from their European counterparts, as surging interest rates in Europe are causing rates in the US to move higher. It makes sense that the ultra-low rates that we saw less than 2 months ago, e.g., 0.05% for a 10 year German bund and negative rates for shorter maturities, could not be sustained. The yield on the German bund has since risen to 0.85% and it has taken with it the yields on US Treasurys, with the 10 year yield now moving up to 2.40%. The most probable cause for the rise in European rates is that the threat of deflation has lessened, with Europe's prospects for growth beginning to improve. Negotiations on the fate of Greece might also be playing a part, although it seems like this is another example of just kicking the can down the road, with no real good news to report here.

Today's big news story was the May non-farm payrolls jobs report, which showed that a larger than expected 280,000 jobs were created in May. This good piece of economic news was a strong indication that we should not underestimate the strength of the US economy, but it also contributed to today's interest rate rise. Investors were hurt by the good news is bad news scenario in which good economic news means that interest rates will rise, the dollar will strengthen, and the Fed will raise interest rates sooner than expected. Both the Dow and S&P 500 dropped today.

Despite the tepid reaction to positive economic news, longer term, good economic news will provide support for the stock market. In addition to the promising jobs picture, auto sales are powering ahead, with projections that a record 17.5 million vehicles will be sold in the US this year. Strength in the housing industry is also expected to spur economic growth.

While rising interest rates will have a negative effect on bonds, I don't foresee a runaway surge in interest rates. Just yesterday, IMF President Christine LaGarde urged the Federal Reserve to put off any interest rate hikes until 2016. Her reasoning is that the global economy is still too fragile to withstand a continued rise in rates. Europe is still battling to stave off deflation and is still several years behind the US in its recovery efforts. Even the US, the world leader in economic growth, posted a negative 0.7% GDP rate for the this year's first quarter, and is on track for only 1% growth in the second quarter. Our economy, even after 6 years of recovery, still is on uneven footing as areas of strong growth are countered with pockets of weakness.

Any further increases in interest rates should therefore be somewhat muted. Bonds have faced headwinds thus far this year in the face of rising interest rates. But now with the rates at higher levels, it is doubtful that the struggling global economy can support rates at much higher levels. Stable rates going forward along with their higher yields should offer better returns for bond investors in the second half of this year.

For many of my clients, I have added exposure to international funds during the past month. The general consensus among investors has been that the European recovery has lagged the US recovery by about 2 years, and that the gains seen in US markets during this time might begin to be seen overseas. I have held off until now because the European stock markets have had difficulty gaining traction. But these markets have begun to outperform the US markets this year by a significant margin. Unemployment is looking better in the northern countries like Germany, but improvements are also being observed in southern countries like Spain.

The European Central Bank President Mario Draghi has virtually guaranteed that he will be vigilant in his monetary support of the member nations and in his quantitative easing program. This will help to keep interest rates low and to keep the value of the Euro down to help exports. Europe is also benefiting from cheaper energy prices. European earnings have been flat for about 5 years. This situation now appears to be improving. *Jeff Feldman*

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