BULL & BEAR BULLETIN

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Bond Market Defies Logic:

At the beginning of the year investors firmly believed that 2014 would be the year that interest rates finally moved higher. A 2% economic contraction in the first quarter put that premonition on hold, however, as the economy regains its footing, expectations are growing that the Federal Reserve may raise interest rates sometime in the next 12-18 months. Combined with the projected conclusion of the Federal Reserve's money printing efforts (QE3) in October, an investor would expect interest rates to resume their march higher.

Despite historical examples to expect interest rates to be moving higher, the yield curve (a graphic representation of interest rates over various time maturities) has actually flattened out over the past two months (graph 1). The yields on short-term bonds have moved up slightly, but bonds maturing in more than 10 years are relatively unchanged.

Market pundits are left to speculate why interest rates are defying investor logic. One of the more prevalent explanations is the yield advantage U.S. government bonds have over their European counterparts (graph 2). Not only do U.S. government bonds offer higher interest rates than many European government bonds, they are generally considered to be less risky than European government bonds. The risk-adjusted profile of U.S. government bonds has made them more attractive to foreign bond investors and according to the U.S. Treasury Department, foreigners acquired a net $130 billion worth of Treasury bonds through the first five months of this year.

In addition to having higher interest rates than foreign markets, geopolitics has likely been a catalyst for bond buying activity. As long as tensions remain high in the Middle East and in the Ukraine, investors will seek out additional protection through the U.S. Treasury market.

Another possible explanation for the minimal response in the bond market is disbelief that the Federal Reserve will be able to raise the Federal Funds Rate significantly this business cycle. Many investors still cite structural headwinds in the economy, such as the lack of credit expansion, consumer debt levels, and stagnant wages as reasons inflation will remain low and as impediments to the Federal Reserve's desire to lift interest rates.

Reflecting on the market adage, "the market can remain irrational longer than an investor can stay solvent", it may not matter the exact reason interest rates have defied investor logic. What is important is the direction of the economy and the degree the economy is able to absorb higher interest rates in the future. The momentum and stability of the economy will dictate our assessment on whether bond prices face risks posed by higher interest rates and how this may affect an investor's unique portfolio needs.

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Chart 1

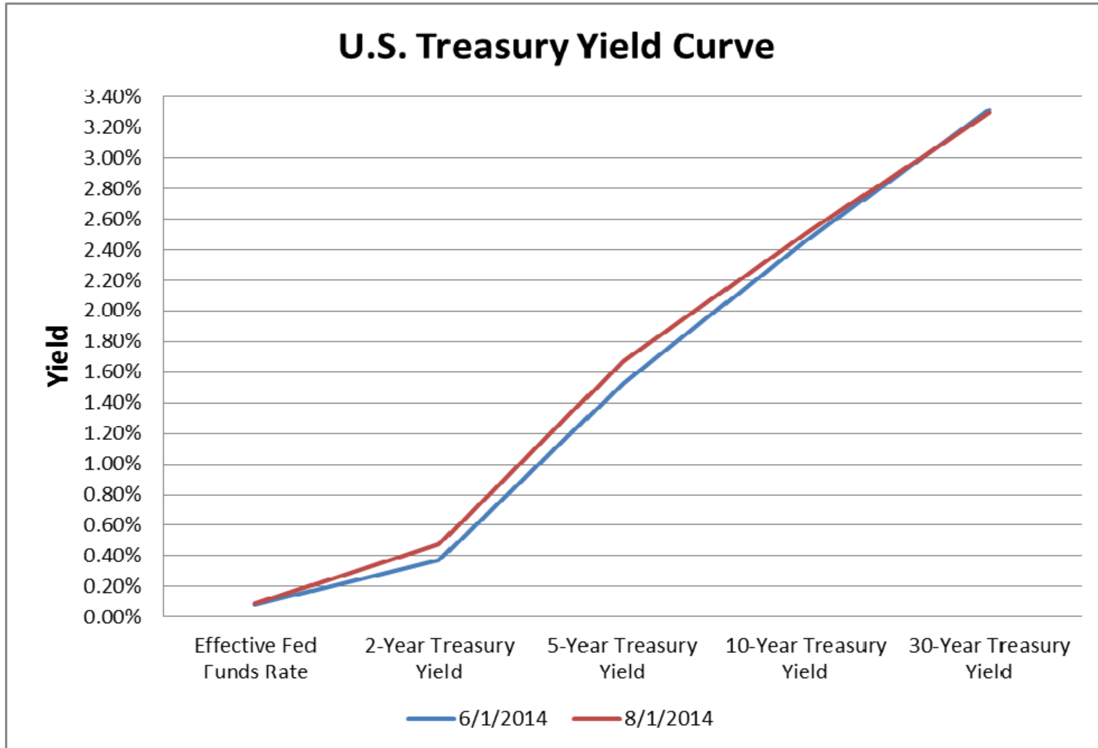
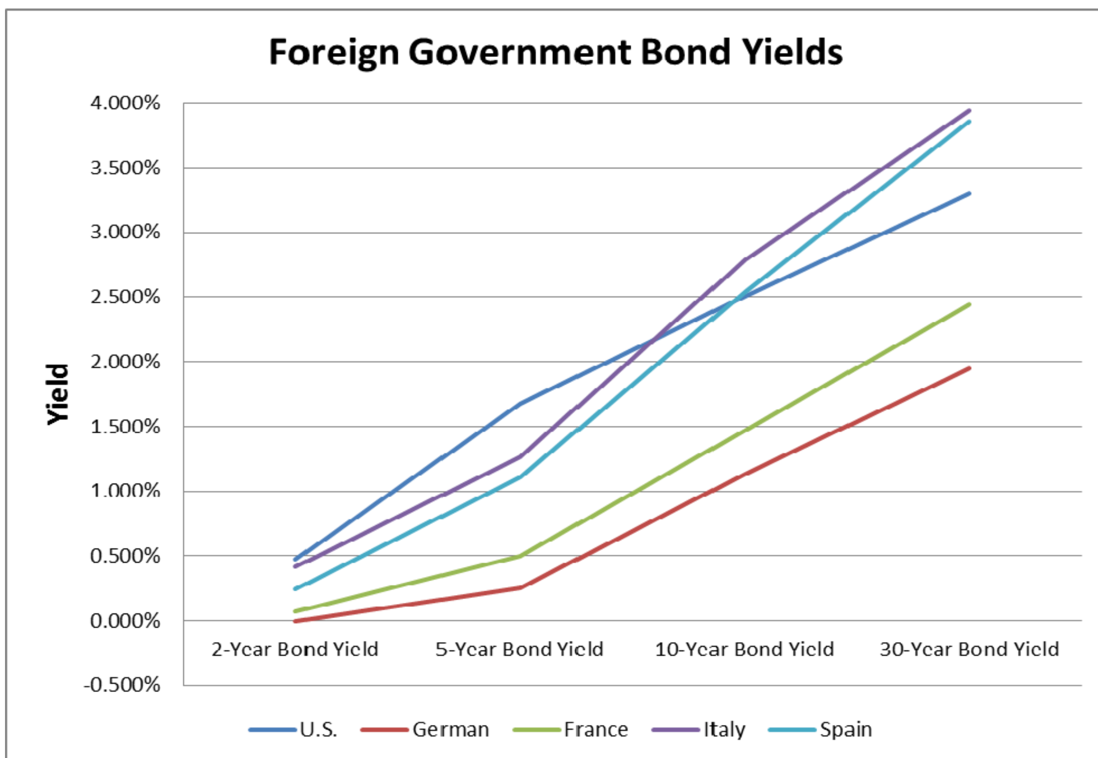


Chart 2



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