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Stocks Stagnant, Bonds Drop:

Over the last month, stocks have maintained their flat year-to-date pattern, but the bond market has started to exhibit renewed volatility and increased selling pressure. There are several possible explanations for the increased selling pressure on bonds that have pushed yields to their highs of the year (Chart 1).

One reason bond prices may be moving lower and yields higher (an inverse relationship that exists with bonds) is to adjust for renewed signs of possible inflation in the U.S. Average hourly earnings in the U.S. bumped to 2.3% in May, the highest level of the current economic expansion and well above the 0.04% average for the expansion. Coupled with continual improvements in the number of jobs added on a monthly basis and the benefits from lower fuel prices, there is growing optimism that consumer spending should accelerate and put upward pressure on price stability.

The prospects for greater inflation pressure have improved the probability that the Federal Reserve may increase interest rates for the first time since 2006 (Chart 2). Investors now believe there is a 56% chance that the Federal Reserve will raise interest rates at its June 16th meeting and, if not in June, a 55% chance rates will be lifted at the July 29th meeting. Expect greater investor positioning in advance of any interest rate hike, leading to greater selling volume within the bond market.

The sudden shift in investor appetite for European bonds may be another explanation for the recent increase in U.S. yields. Despite the European Central Bank beginning its own Quantitative Easing (QE) program, many of the European Union countries have experienced near record jumps in yields. The average German government bond yield for bonds maturing in the next 3-5 years has gone from (0.20%) to 0.02% in the last six weeks, which coincides with the move back to year-to-date highs in U.S. Treasury yields. The sell-off in European bonds may be a by-product of investors recognizing the insanity of purchasing bonds that charge interest to own them or a growing belief that the European QE will succeed in reinvigorating Europe Zone's economic growth.

We feel the Federal Reserve has provided significant communication to investors and foreign central banks that it intends to end the near-zero interest rate policy. While the contraction in the U.S. economy in the first quarter may have muddied the waters on the timing of an interest rate hike, the odds are still favorable for an increase sometime this year. What is clear is the probability that any interest rate increase is likely to be accompanied by a lengthy period of digestion before a subsequent interest rate hike. So, despite investors positioning themselves ahead of a pending hike, barring any drastic acceleration in inflation and credit expansion, we do not expect a significant decline in the bond market once the Federal Reserve does ultimately decide to adjust interest rates. It is our belief that it may be best to weather the bond market volatility rather than take dramatic steps to significantly reduce bond exposure at this time.

Chart 1

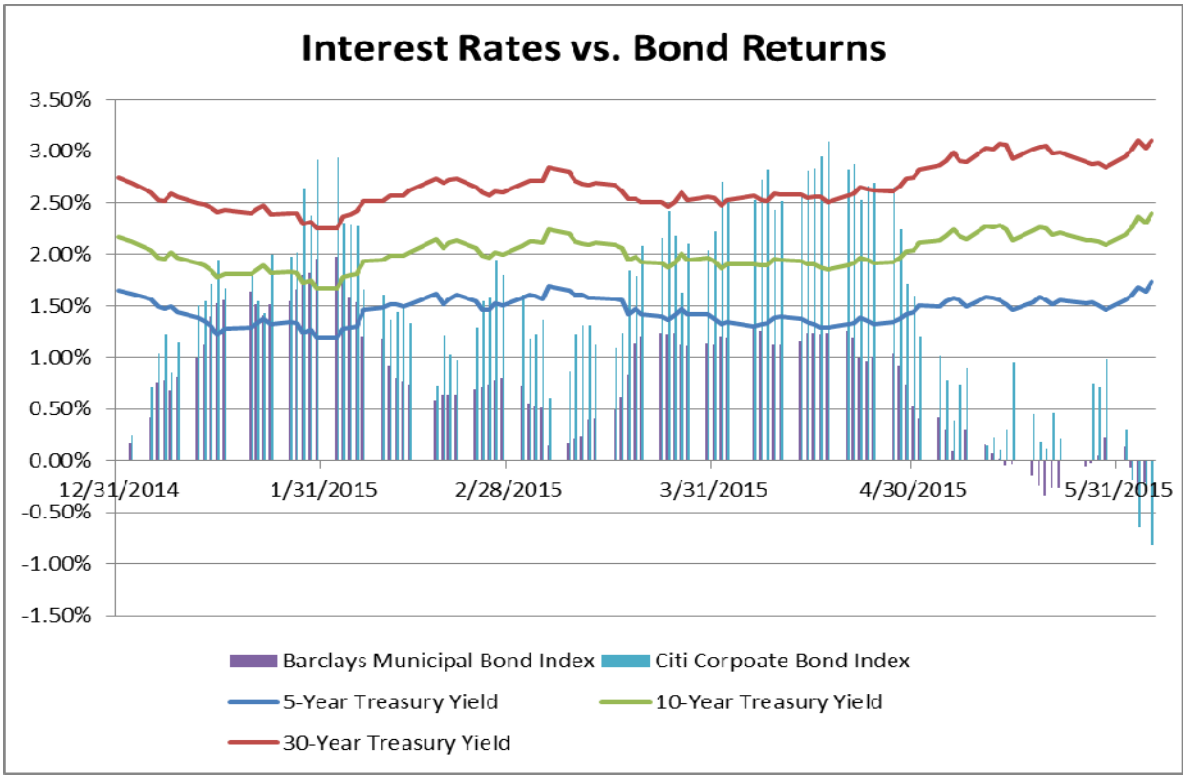

Chart 2