BULL AND BEAR BULLETIN

Is a Bond Bubble Developing?

In an effort to offset the deleveraging process from the collapse of multiple asset bubbles, the Federal Reserve has lowered interest rates to unprecedented levels (Chart 1). With fixed income investments offering very little in the way of real returns, there is a growing possibility that the Federal Reserve has actually created the next market bubble.

Excluding insolvency and the corresponding failure to receive a return on the principal investment, inflation and higher interest rates are the two greatest risks to fixed income investments. Traditionally, normalized interest rates offered a modest level of protection from both higher interest rates and inflation, however, in today's Federal Reserve induced zero-bound interest rate market, new bond purchases may leave little protection against sizeable losses from inflation or an upward move in interest rates.

Directly speaking, higher inflation does not have an impact on the actual pricing of a bond, but the higher cost of living erodes the "real" return captured by a bond investor by offsetting a portion of the semiannual interest paid to the bondholder. As an example, if a bond pays an investor 6% per year in interest and inflation is 2%, the real return is only 4%.

The loss of purchasing power has become magnified in today's low interest rate environment. A 10-year U.S. Treasury bond is paying investors 1.8%, while inflation in the month of March was up 2.7% versus a year prior, leaving an investor with a negative real return of 0.9%. In order to capture a positive inflation adjusted return on a U.S. Treasury bond, an investor would have to purchase a bond that does not mature for nearly 30 years. The extended time frame forced upon investors unfortunately places the investor at risk for our second item - higher interest rates.

As interest rates move higher, existing bonds become less attractive compared to any newly issued bonds that pay a higher interest rate to investors. In order to make the existing bonds equal to any newly issued bonds, the price on the existing bonds must be lowered. As the price level falls on an existing bond, the total expected return on the bond, called the "yield", begins to move closer to the expected return of the newly issued bond. For example, if an existing bond has a coupon of 5% and is trading at a price of $110.00, in order for the bond to become as attractive as a newly issued bond with a coupon of 8% and a price of $100.00, the price of the existing bond must decline.

Traditionally, the greater the existing yield on a bond and the shorter the time to maturity, the more protection the bond provides against an upward move in its interest rate. In today's record low interest rate environment, bond investors are awarded very little protection. Currently, a 30-year U.S. Treasury bond would experience a 9.0% loss in price if interest rates were to increase just 0.5% and would lose 17% if interest rates increase a full 1.0%.

To frame this risk/reward relationship, an investor is going to receive a yield of 2.9% over the 30-year life of the bond, but could see price fluctuations that are 3 to 5 times the expected rate of return. Factoring in the average inflation rate of 2.3% over the past five years, an investor is capturing little real return while assuming significant risk of price volatility.

While the Federal Reserve has committed to keeping interest rates extremely low for at least the next 18 months, an investor has to consider the prospects of at least a 0.5% to 1.0% increase in interest rates over the next 30 years. Unfortunately, the market data indicates that many investors either view the risk/reward relationship of bonds as a superior alternative to stock ownership or fail to grasp the risks they are assuming by purchasing bonds at these ultra low interest rates. Data by the Investment Company Institute shows that investors added $94.5 billion worth of new monies to bond funds in the first quarter of the year, despite the 30-year U.S. Treasury yield hovering near all time lows (Chart 2).

Although some investors find themselves on fixed incomes and require the stability associated with bond investments, the new market dynamic created by the Federal Reserve may force some investors to reconsider equity investments as an alternative. Currently the S&P 500 Index, which holds the 500 largest US-traded companies as measured by market capitalization, is offering a dividend yield of roughly 2.0%. Likewise, there are many large U.S. companies with long histories of profitability that offer dividend yields exceeding 3.0%.

Equity investments are often shunned by investors seeking the stability of fixed budgets investments. Considering the potential price volatility previously outlined for long dated Treasury bonds, many investors may already be assuming the same price volatility as the stock market. At least with dividend paying stocks, there exists additional upside potential from price appreciation, while it will become more difficult to expect further price appreciation in bonds as interest rates continue to find new all time lows.

Most investors continue to assess the risk associated with sluggish growth in the U.S. economy and the default risks with several European nations. They see and view the above average bond market returns from the past few years and feel that the usually reliable bond market remains the best bet. As investors continue to put new monies into the bond market and the Federal Reserve maintains its promise to sustain a low interest rate environment, the potential risks associated with a market bubble silently grow.

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Bond investors should be aware that the top in the bond market may be triggered by one of several events- a significant increase in inflation, a revolt by the bond market against financing the growing U.S. deficit or a re-acceleration of the U.S. economy. Even acknowledging the possible tops to the market, the challenge for investors will be to recognize the moment the bubble bursts and to minimize their losses before the market responds. Traditionally, the moves are far greater than investors anticipate and leave them little time to respond.

Our general bond market investment strategy consists of selecting bonds that have higher yields and maturities of less than 10 years in an effort to limit the risks associated with higher interest rates and inflation. We are also advising against any significant new investments in the bond market, as new purchases at existing yields may offer investors less appreciation than those gains already experienced by existing fixed income holdings and could expose clients to long-term price volatility that exceeds the limited expected returns.

Chart 1

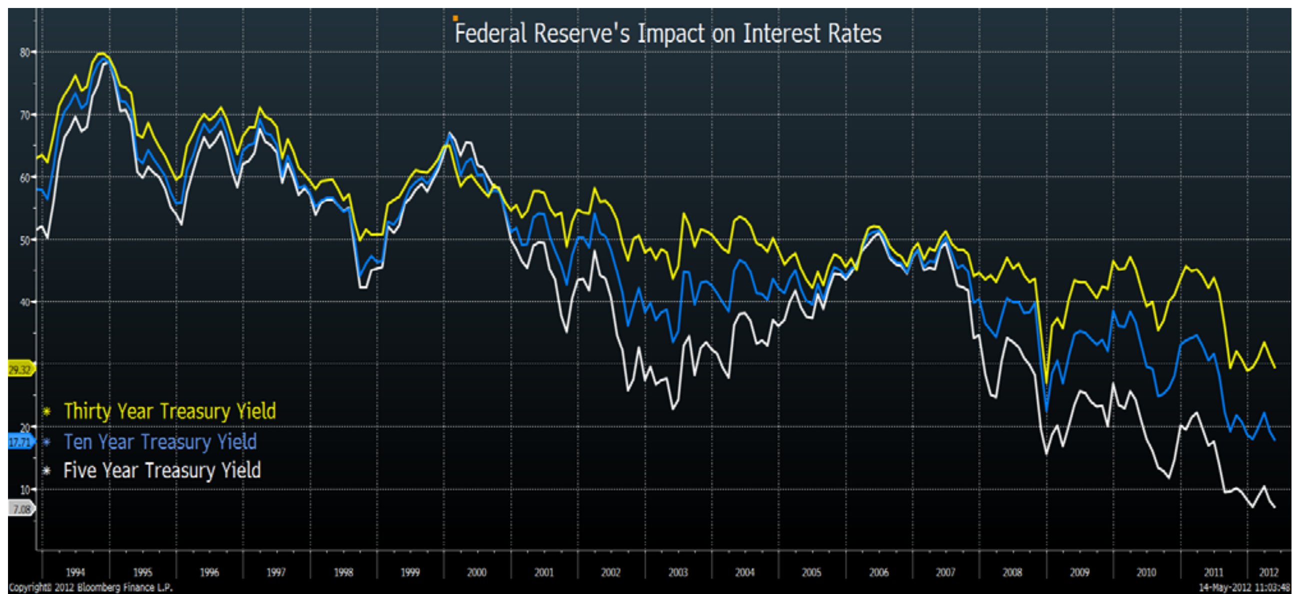
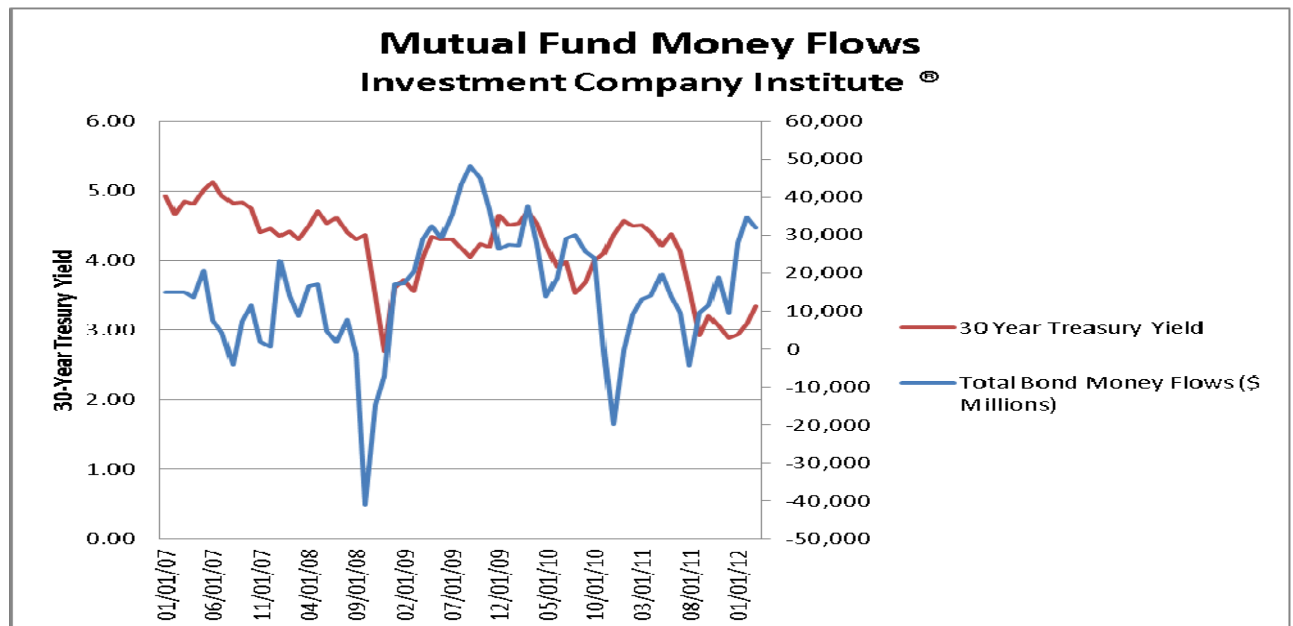


Chart 2



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