Bond Market Update

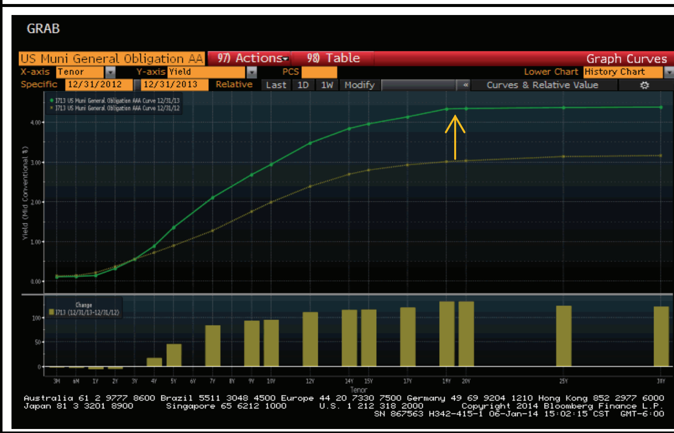
As of December 31, 2013 / Volume 2, Issue 4 / FFTAM.COM

Happy New Year! As we start 2014, looking back upon 2013 provides some helpful insights as to what we might expect for 2014. The fixed income markets in 2013 performed slightly less than expected. For the year, total returns on taxable securities came in at –0.53% and total returns on tax-free securities came in at –0.76%. The slightly negative returns for both sectors can be attributed to expectations in the market that the Fed would start the slowing of its $85 billion in monthly purchases. During the December Federal Open Market Committee meeting, Chairman Bernanke announced that starting in January 2014 the pace of monthly purchases would slow to $75 billion. In addition, Chairman Bernanke announced that it is the committees' intention to stay highly accommodative for the foreseeable future. On the surface, these two remarks seem contradictory and confusing. However, looking at the US Treasury yield curve helps brings these two comments into perspective. Figure 1 below is the Treasury curve as of 12/31/2012 and 12/31/2013. As you can see, ending the year resulted in a substantial steeping of the yield curve as intermediate and long maturity assets went up in yield (the arrow indicating a major increase in yield). This result is due to the Fed's guidance and the Fed's expectations as it relates to its bond purchase program. The very short maturity assets were little changed as a result of the Fed communicating its stance of being highly accommodative into the foreseeable future.

Figure 1

Source: Bloomberg

Figure 2



Source: Bloomberg

Figure 2 above is the AAA Municipal General Obligation curve as of 12/31/2012 and 12/31/2013. The end of year results and conclusions are very similar to the taxable market. However, taking into account that tax-free rates moved almost one for one with taxable rates in addition to higher tax rate burdens results in substaintially higher tax equivalent yields.

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From an economic standpoint, 2013 proved to be a good year. ISM Manufacturing and ISM Non-Manufacturing showed readings above 50 throughout the year (any reading above 50 represents expansion in the economy). Continuing jobless claims steadily declined to early 2008 levels and the unemployment rate dropped to late 2008 levels. GDP averaged 2.5% for the first three quarters of 2013 and shows signs of an expectedly strong fourth quarter. Looking forward, consensus is that 2014 will slightly exceed 2013 targets.

As 2014 begins, the yield curve for taxable bond markets and tax-free markets have steepened substantially. This steepening should be viewed as an excellent opportunity to sell short maturity assets (1 to 3 years) and buy intermediate to longer maturity assets (4 to 7 years for taxable and 7 to 18 years for tax-free). As long as the yield curve remains steep, excellent roll down potential exists. If rates move up slowly, total returns should be very similar to shorter maturity assets.

During the early part of 2014, Janet Yellen will assume official duties as the new Federal Reserve Chairperson. Much is still unknown about the new head of the Fed, however, after her speech last month, the markets are expecting more of the same policy already in place. Yellen will have her plate full as it is expected she will slowly reduce the current program of asset purchases. As pointed out earlier, most of the move in bonds in 2013 can be explained by the markets expectation related to the Fed's bond purchase program. As the actual removal of stimulus takes place, a major risk exists that a repeat of the performance of the bond markets might recur. It is generally held that the slowing of the Fed's purchases and ultimate removal is already priced into the market. The risk to the bond market is that the actual pace of removal is faster than expected. With this in mind, extension trades that have built in defensive characteristics offer the best total return profiles.

Overall, bonds provide a source of stability within an investment portfolio relative to stocks. The upcoming year should provide opportunities for active bond management to add value beyond buy-and-hold strategies.

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