Is the Party Over for Bonds?

The bond market has been on a roll for over 30 years as yields have come down steadily to historically low levels. Now where is an investor to go for income? Can bonds continue to provide stability of principal? Is the party over? The punchbowl may be near its bottom, but in this quarterly letter we remind investors of the purpose of bonds in balanced portfolios, explain how we got to this low level of bond yields, and what might happen when rates normalize. Finally, we will provide some perspective on how we are managing through an unprecedented era in the bond markets.

Role of bonds in balanced portfolios
An allocation to investment-grade bonds in a portfolio is used to provide stable income and liquidity, as well as principal preservation during times of market volatility. Low correlation to equity markets, especially during down markets, provides diversification when it is most needed. In the “lost decade” for stocks (2000-2009), during which the S&P 500 Index return was near zero, the Barclays Aggregate Bond Index returned 6.3% per year.

In fact, this bull market in bonds continued through 2012 even as the US economy slowly came out of the recession of 2008-2009. The ten-year treasury yield, often used as a proxy for the bond market, hit a new all-time low of 1.4% last July. This level was lower than the low experienced in December 2008 during the height of the credit crisis and recession that ensued. Currently, the ten-year treasury yield stands at 1.8%, still below the yield reached in late 2008. The chart below illustrates the yields on 10-year US Treasury issues since 1965 (recall, prices rise as yields fall).

10-Year Treasury yields: The bull market for bonds has lasted for 30 years

Besides income and liquidity, bonds provide an important additional role: stability in volatile markets. The following table compares two simple portfolios: one invested 100% in U.S. stocks and one invested 50% in stocks and 50% in bonds. Note the reduced volatility and downside protection for the balanced portfolio. In reality, portfolios that are even more diversified with investments in international stocks and bonds, high yield bonds, commodities, preferred stocks, and real estate can further enhance returns with reduced volatility.
How did we get here?
How can yields be lower than during the greatest financial crisis our nation has seen since the Great Depression? Historically, the bond market has traded based on prospects for the economy and inflation, with yields falling during recessions and rising during recoveries. U.S. Gross Domestic Product has grown for 12 consecutive quarters now and we’ve added over 5 million jobs since the recession ended. Yet the 10-year yield has not increased from the depths of the recession – in fact, the opposite has happened.

So why are yields not following an improving economy? We are in a new era where numerous technical factors are affecting the bond market. Specifically, the Federal Reserve’s monetary policy, ongoing international credit concerns, and changing demographics all play an increasingly important role in the bond market. Before the 2008-2009 Great Recession, the Federal Reserve managed a single short-term interest rate, the Fed Funds rate, in order to meet its targets for inflation and unemployment. Since the financial crisis, in addition to targeting the Fed Funds rate near zero, the Federal Reserve has been purchasing treasuries and mortgage backed securities in a technique called “quantitative easing.” These actions are affecting longer-term yields, lowering mortgage rates as well as other consumer and business borrowing costs.

Based on recent economic data, it appears that quantitative easing is working. As mentioned in our last quarterly letter, housing and auto sales, just two economic data points, are showing signs of improvement. With continued improvement in economic data, we should see yields start to move up. How far up though will depend on the Federal Reserve’s interpretation of the economic data and whether they believe the improvement is sustainable. We still have millions of people unemployed, and even underemployed, and that may take years to work through.

The Federal Reserve may begin their quantitative easing exit strategy by slowing bond purchases later this year and then stopping them altogether sometime in mid-2014. The Federal Reserve has committed to keep the Fed Funds rate near zero until unemployment falls to 6.5% as long as inflation remains under 2.5%. This is estimated to occur sometime in 2015. If unemployment falls at a faster rate than expected, or if inflation shows signs of overheating, the Federal Reserve could put the brakes on bond purchases and begin raising the Fed Funds rate sooner. So much uncertainty! Therefore, we are managing bond investments in a defensive manner.

We may be at the foothills of higher rates, but there are several significant themes likely to keep interest rates within a continued low range. The U.S. dollar is still the reserve currency in times of uncertainty, and Europe is not out of the woods yet. While the European Union has made progress on austerity as well as backing up troubled countries and financial institutions, they have a long way to go. The recent Cypriot banking crisis is a fresh example. While Cyprus itself is a small country and its banking crisis appears contained, there is a risk of contagion in Europe. As long as there is perceived risk in Europe, there is generally a flight to safety in dollar

### Adding Bonds Reduces Volatility

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<th>Largest Gain</th>
<th>Largest Loss</th>
<th>% of Years Positive</th>
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Source: Ibbotson Associates: data from 1972 to 2010

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denominated risk-free assets, namely U.S. Treasuries. This demand keeps treasury prices high and yields low.

Additionally, the Federal Reserve’s current bond purchase program continues to elevate this supply/demand imbalance. The chart below shows how total bond issuance compares to the Federal Reserve’s current demand. Issuance has declined since 2010, yet demand from the Federal Reserve has increased. This leaves little supply for investors looking for safe assets such as bonds, pushing down yields.

Federal Reserve Bond Purchase Activity

Another source of continued demand for fixed income instruments is our aging demographics. Baby boomers now reaching retirement age have a greater need for fixed income securities that have principal protection and predictable income. This demand keeps prices high and yields low.

So when will rates rise?
While no one knows the answer to that, we believe there is greater risk of rising rates than further declines. One possible scenario is for interest rates to rise gradually but cause investors to flee the bond market in earnest, accelerating yields up even further. It is for this reason that we continue to manage portfolios in a manner that attempts to reduce interest rate risk. The longer the maturity of a bond, the greater the price change resulting from a rise or fall in interest rates. If rates rise quickly by 1%, the price of a 10-year bond could fall by 7% or more.

Covington’s strategy
Given the potential risk in the bond market, one may think the best strategy is to exit the sector completely. While we do believe stocks currently represent better value than bonds, there is always a need for a bond allocation to provide stable and predictable returns. We want to protect our clients’ investment portfolios by remaining short in our average maturities and nimble with regard to sector allocation, maturity allocation, and credit selection.
While managing portfolios to a shorter maturity than normal, we can increase yield through investments in non-government issued bonds such as bonds issued by large corporations, mortgages, and emerging market debt. As seen in the yield curve below, investing in corporate bonds and mortgage bonds offers substantially more yield than treasuries and continue to provide opportunity. The highlighted area on the chart shows that a 5-year A-rated financial corporate bond may yield 1.9%, while a 5-year treasury yields 0.8%. Floating rate bonds should also do well even as rates rise.

**Investment Grade Yield Curve**

![Yield Curve Chart]

Source: Bloomberg

In our taxable portfolios, where tax-exempt municipals are appropriate, we are maintaining our up-in-quality bias. Given fiscal uncertainty at the federal and municipal level, we emphasize liquidity via high grade general obligations and essential service revenue bonds and are finding value in high coupon callable bonds. The demand for municipal bonds, especially with the prospect of higher taxes, should lend support to the general municipal bond market and a diversified portfolio of high quality municipal bonds with a short-intermediate average maturity should continue to serve investors well.

An improving economy and a more stable international dynamic should lead to slightly higher rates going forward; however, continued easy monetary policy due to high unemployment, fiscal headwinds, and strong technical demand for bonds should keep bond yields from rising rapidly. Returns on bonds will inevitably be lower for the coming years than recent history, but there remains a need for bonds in a balanced portfolio. While the party for bonds may be nearing its end, there is still a little juice left in the punchbowl to enjoy.