Perspective

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At a Glance...

Bonds: Life after a 20-Year Rally

Bonds

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The 15-20 year rally in the United States fixed income market is likely near its end, but investors who have used asset allocation strategies which included fixed income as part of their allocation have benefited handsomely from this remarkable rally. Several factors have contributed to this bond bull market, not the least of which was the worst economic recession in the United States since the Great Depression, caused by the collapse of the housing and financial markets in late 2008. The entire world watched to see if the United States financial system would collapse and, luckily for bond investors, it withstood the challenge with a little help from the Federal Reserve.

Essentially, ever since the Great Recession, the Federal Reserve has maintained a very accommodative stance on interest-rate policy, committing to keep interest rates low for an extended period of time, with the likely first increase in short-term rates scheduled for June 2015. The Federal Reserve has been very transparent about their willingness to keep rates low for an extended period of time. The bigger issue is how long Federal Reserve chairperson Janet Yellen can maintain her super-dovish interest-rate policy without it creating unintended consequences for the United States equity and bond markets and the world economy. Yellen has said all the right things to keep investors on Wall Street happy. She has even continued her dovish stance during a period where U.S. unemployment rates have reached her earlier targets. Yellen says that the reason for the drop in the U.S. unemployment rate is partially due to job seekers dropping out of the workforce who are unable to find work and pay related to their skill level and training. In other words, there are a number of under-employed workers and workers who have just given up in finding jobs related to their experience and training. It is unclear how keeping interest rates low for an extended period of time will help these job seekers gain full employment.

Also wage pressure yet to be felt by employers is keeping a tight lid on inflationary pressures. As soon as workers can demand higher wages and there becomes true price pressure or competition for jobs, inflation will likely materialize. Another recent

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development that is keeping inflation at bay is the threat of deflation. Deflation remains a global concern, especially in Japan. Deflation can have dire consequences for the economy as consumers forestall purchases in hopes they will become less expensive if they wait. Falling commodity prices can place downward pressure on prices as well. Europe, Japan and the United States have all printed money in hopes of reflating their respective economies and avoiding the dreaded deflationary spiral. Most recently, Japan has embarked on an even more aggressive program to prop up prices of goods and services by expanding the definition and amount of their asset purchases. Japan will be targeting asset purchases which include bonds and stocks. The news from Japan drove the United States financial markets to a record close and allowed the averages to recover quickly from a recent October correction.

The recent decline in world oil prices has only exacerbated deflationary concerns. World oil prices are dropping due to lower global demand and because the United States has become energy independent due to advances in fracking technologies and an abundance of shale resources. While lower oil prices are great for the US consumer and also for companies who use petroleum products for inputs, lower oil prices hurt oil and gas exploration and big oil companies.

Given all the cross currents facing the global economy and potential head winds from Europe, it is likely interest-rate policy in the United States will remain subdued for at least the next 12 months. Moreover, when rates do rise, hopefully it will be due to stronger world economic growth. Ideally, Yellen would like to raise rates enough so she has some leverage for the next economic downturn to lower rates and stimulate the economy. Though Yellen has probably done her best to stimulate the US economy, we hope her game plan addresses multiple potential outcomes. In college calculus, one of the biggest challenges was solving for multiple variables. Let's hope Yellen is better at calculus than most and has the patience and perseverance to address the difficult challenges ahead for the fixed income market and the world economies.

At HighTower Bellevue, our fixed income strategy for our client portfolios addresses many of these current circumstances. We have taken great care to design and select managers who can navigate the current bond or fixed income market. We also have constructed our current bond allocation to address the extremely low interest rate environment, and avoid areas of the fixed income markets that are very over-priced, namely long date treasuries and high yield bonds. Finally, we believe strongly that fixed income needs to be a part of every asset allocation portfolio. Fixed income provides diversification from equity risk and lowers overall portfolio standard deviation when combined with equities.