Market & Investment Insights

2013 Fourth Quarter Fixed-Income Market Review

Bill Martin, Head of Fixed-Income Portfolio Management

Article Highlights:

- Fixed-income results were mixed in the fourth quarter. Rising interest rates hurt U.S. Treasuries and the broad fixed-income market, which posted a modest decline for the quarter and its first annual loss since 1999. High-yield and investment-grade corporate bonds were the quarter's top performers.
- The Fed's highly anticipated decision to taper its quantitative easing asset purchases helped push the 10-year Treasury yield higher, but markets generally took the news in stride.
- To keep long-term rates in check, we expect the Fed to continue taking a measured approach to winding down its bond-buying program.
- While we don't foresee outsized fixed-income gains in 2014, well-diversified bond portfolios could deliver positive performance, and total returns could surpass those of 2013.

February 7, 2014

Bonds produce mixed quarterly results

Results for the major bond-market indexes were mixed for the fourth quarter, but nearly all finished the year in negative territory. Rising interest rates hurt the broad Barclays U.S. Aggregate Bond Index, which returned -0.14% for the quarter and -2.02% for the year, its first annual loss since 1999. A declining default rate helped investment-grade corporate bonds gain 1.11% for the quarter, but they finished down (-1.53%) for the year as a whole. Their high-yield counterparts advanced 3.58% in the fourth quarter, reflecting a strengthening economy, and for the year they rose 7.45%— making high yield the best performer by far among major fixed-income asset classes. U.S. Treasury returns were negative (-0.76%) for the quarter and for the year (-2.75%). Emerging-market debt continued to heal from last spring's selloff, but its positive fourth-quarter return (+0.64%) did little to temper a sharp loss for the year (-7.04%).

Tapering and economic news influence Treasury yields

After beginning the quarter at 2.64%, the bellwether 10-year U.S. Treasury yield fell modestly in mid-October as the market welcomed Congress's deal to reopen the federal government after a 16-day shutdown and lift the debt ceiling. In November, a stronger-than-expected jobs report put upward pressure on the 10-

Financial Services

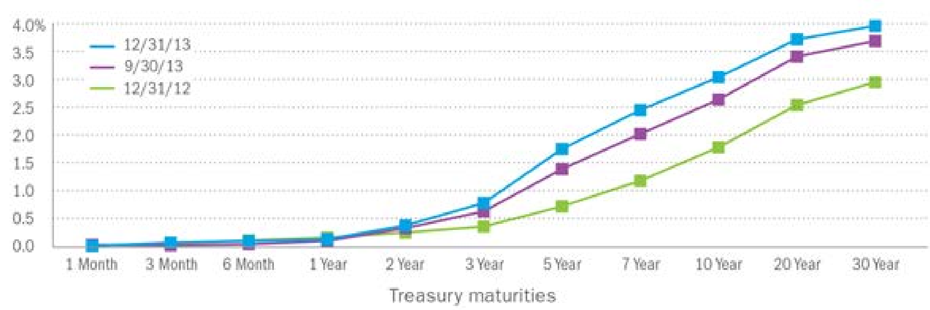
year yield, which climbed to 2.75% by month end. Then, on December 18, the Federal Reserve put an end to months of speculation by announcing it would begin tapering its quantitative easing bond purchases in January. Although yields rose in the wake of the Fed's announcement, U.S. Treasury markets were much more muted in their response than they had been earlier in the year, when the fear of imminent tapering caused a spike in the 10-year yield. For the quarter, the 10-year yield rose by 40 basis points (0.40%) to 3.04%, a 2½ year high. (Exhibit 2 shows the path of the 10-year yield throughout the quarter.)

The yield curve continues to steepen

As shown in Exhibit 1, Treasury yields for maturities from 3 months to 3 years moved up modestly during the fourth quarter, while yields for maturities from 5 to 30 years generally rose sharply. Rates were mostly higher across the curve by the end of the year (as shown by the blue line in the graph) than they were at the end of September (red line), and they were significantly higher versus the end of 2012 (green line), with the largest increases occurring in bonds with maturities from 5 to 20 years.

Exhibit 1

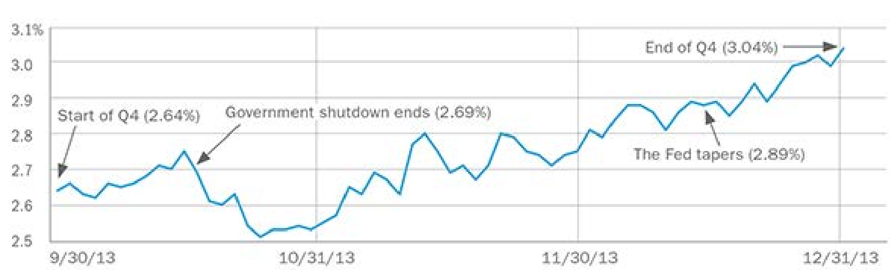
The treasury yield curve steepened in Q4



Source: U.S. Treasury data.

Exhibit 2

After dipping in October, the 10-year treasury yield headed higher



Source: U.S. Treasury data.

The steepness of the curve reflects investor expectations of continued economic growth and the eventual end of quantitative easing, a combination that will likely lead to higher long-term rates. Astute security selection in particularly steep sections of the curve may offer the opportunity for price appreciation as the bonds approach maturity. (Assuming a positively sloped yield curve, a bond nearing maturity potentially may be valued at successively lower yields and potentially higher prices. Investing in these bonds in an attempt to take advantage of such opportunities is a strategy known as “rolling down the curve.”)

Fiscal and monetary policy add a dose of certainty for financial markets

The biggest story in the fourth quarter—and perhaps for the year—was the Fed’s decision to begin tapering. The central bank, which had been buying $85 billion of U.S. Treasuries and mortgage-backed securities every month since September 2012, announced that it would reduce this monthly amount by $10 billion beginning in January 2014. The Fed also distinguished between “tapering” and “tightening” (that is, raising interest rates) as its guidance indicated that short-term interest rates would remain at near-zero levels until late 2015.

To reassure markets and help keep long-term rates in check, we expect the Fed to take a measured approach to trimming its monetary stimulus. It is clear that the central bank would like to avoid repeating last spring’s “taper tantrum,” when a discussion of tapering by Chairman Ben Bernanke led to a sharp increase in the 10-year yield, from 1.70% on May 1 to 2.25% in just 6 weeks. This spike hurt the housing market, employment growth, and private-sector investment. Should long-term rates rise too quickly during the taper, we anticipate that the Fed will adjust policy as appropriate.

During the quarter, monetary policy shared the headlines with fiscal policy. The period kicked off with a government shutdown that lasted until Congress hammered out a bipartisan deal on October 16. Although only a temporary fix, the agreement eliminated both the direct drag on economic activity caused by the government shutdown and the imminent risk of a potential U.S. government default.

In December, Congress passed a bipartisan budget agreement that, while narrow in scope, will ease near-term gridlock and provide fiscal clarity for the next two years. In addition, it will likely boost confidence and stimulate both consumer spending and corporate investment. While the risk of another budget standoff has been avoided, it is worth noting that the U.S. Treasury will hit its official debt-ceiling on February 7, 2014, setting the stage for what might be yet another showdown in Washington.

Outlook

We believe that fixed-income markets are fundamentally strong: the risk of corporate defaults remains low, corporate releveraging (the accumulation of debt following a period of paying it down) is modest, and liquidity for nearly all issuers is healthy.

In terms of portfolio positioning, fixed-income investors may be well served by seeking value in less interest-rate-sensitive segments such as non-agency and commercial mortgage-backed securities, as well as in high-yield corporate bonds, which are attractive based on our expectations for continued low default rates.

Overall, we don't anticipate outsized fixed-income gains in 2014. However, we do believe well-diversified bond portfolios can deliver positive performance, and total returns could surpass those of 2013 even if price declines (caused by rising rates) reduce the benefit of interest income. If volatility increases in equity markets, which we expect, bonds could once again play a key role as a core portfolio diversifier.