



Market & Investment Insights

2014 Second Quarter Fixed-Income Market Review

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Article Highlights:

- Fixed-income asset classes added to their strong first-quarter results.
- Declining interest rates helped U.S. Treasuries and the broad fixed-income market post gains.
- Reasonably strong economic fundamentals supported both investment-grade and high-yield corporate bonds, while emerging-markets debt continued to shine.
- We expect more modest fixed-income returns in the second half of the year, as bonds have outperformed expectations since year-end 2013, and Federal Reserve policy continues to shift.

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Bonds extend their gains from the first quarter

Fixed-income markets posted strong results in the second quarter of 2014, supported by a continuation of interest-rate declines that began in the first quarter. The drop in interest rates was a function of several factors, including weaker-than-expected first-quarter GDP growth, “dovish” comments from Federal Reserve Chair Janet Yellen suggesting that the Fed would keep rates low even in the face of stronger economic data, and increased demand for safe-haven fixed-income assets amid geopolitical uncertainty and diminished supply.

Lower interest rates for intermediate- and long-term bonds helped the broad bond market gain 2.04% for the period. Bonds maturing in 10 years or more (+4.72%) easily outpaced those with 1-3 year maturities (+ 0.34%). Treasury Inflation-Protected Securities (TIPS) also performed well. Their relatively long duration in a period of declining rates, along with investors’ desire for protection against rising prices, contributed to a 3.81% return for the overall TIPS market.

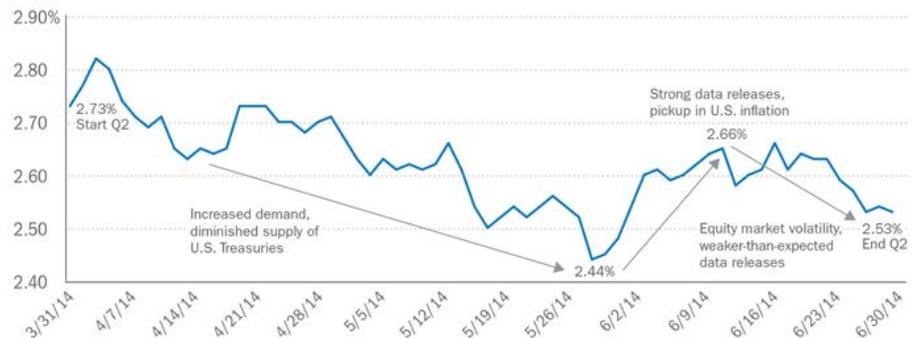
Overall, spread sectors (higher-yielding, non-U.S. Treasury securities) outperformed U.S. Treasuries of similar duration. Positive fund flows helped investment-grade and high-yield corporate bonds return 2.66% and 2.41%, respectively. Emerging-markets debt, which gained 5.35% in the second quarter, maintained its strong run following a sell-off early in the year. A willingness to assume more credit risk, along with declining rates in the U.S., prompted investors to tap into the higher yields available in the developing world.



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Shifting global demand patterns influenced the 10-year U.S. Treasury yield

Exhibit 1: The 10-year Treasury yield fell 20 basis points in the second quarter

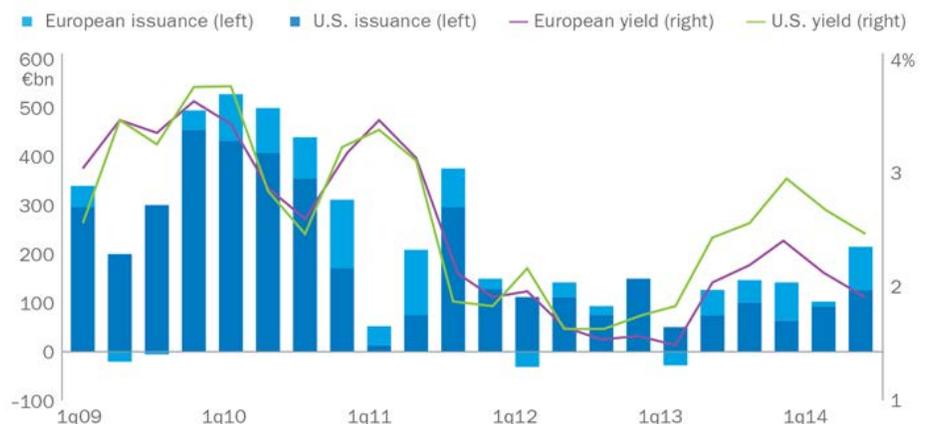


Source: U.S. Treasury data

The yield on the bellwether 10-year U.S. Treasury note dropped 20 basis points during the second quarter, with a few periods of volatility (see Exhibit 1).

After beginning the period at 2.73% and reaching a high of 2.82% in early April, the 10-year yield touched 2.44% on May 28, as shifting global demand patterns for sovereign debt contributed to the decline. European and other foreign buyers anticipating an interest-rate cut and further potential monetary easing measures from the European Central Bank, coupled with a global lack of supply of highly rated debt relative to demand, were key factors behind the 10-year yield hitting an 11-month low (see Exhibit 2).*

Exhibit 2: Issuance of sovereign debt and yields for U.S. and select AAA-rated European countries



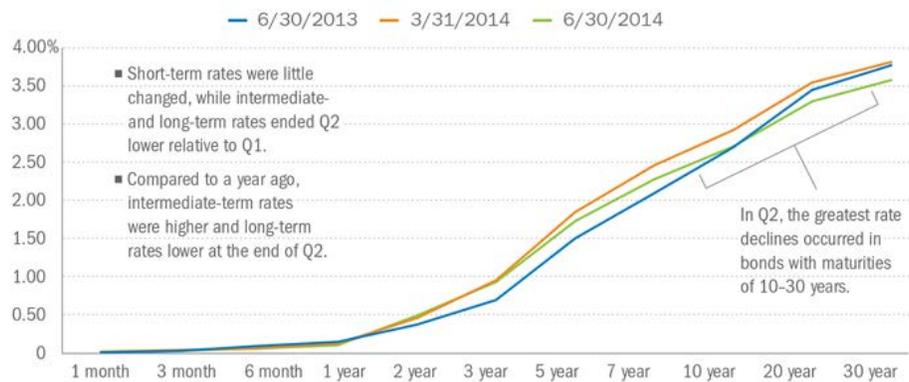
European issuance is for Germany and the U.K. Sources: Sifma, U.K. Debt Management Office, Deutsche Finanzagentur, TIAA-CREF Asset Management. Data is as of 6/30/2014 except for debt issuance through May 2014.
 * For example, net issuance from the United Kingdom fell from £102 billion in the previous fiscal year to just £65 billion this year. Germany is expected to borrow just €6.5 billion in 2014, less than half the amount it had in the previous year.

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The 10-year yield then climbed to 2.66% on June 17 amid improving U.S. economic data and evidence of a pickup in U.S. inflation. U.S. equity market volatility and softer-than-expected economic reports contributed to push the yield down to 2.53% by the end of the quarter.

The yield curve continued to flatten but remained historically steep

Exhibit 3: U.S. Treasury yield curve comparisons



Source: U.S. Treasury data

During the quarter, rates were relatively unchanged for bonds with short maturities (2 years or less), while rates for bonds with maturities of 3 years and longer fell. Declines were greatest for longer-term (10-30 year) bonds, causing the yield curve to “flatten.” A flattening yield curve often signals weak future growth. However, the curve remained historically steep, indicating that investors still expected economic improvement.

Compared to the end of last June, rates increased for notes maturing in 2 to 7 years (with the greatest rise in 3- and 5- year securities) and dipped for bonds maturing in 20-30 years.

It's business as usual from the Fed

Minutes from the Federal Reserve's June meeting demonstrated the Fed's belief that economic and labor market conditions were improving, thereby supporting the continued tapering of the Fed's monthly bond purchases. The minutes also set the expectation for tapering to end at the Fed's October meeting.

On the interest-rate front, Fed officials agreed to keep rates near zero “for a considerable time” after its tapering program ends. We do not expect a change in rates until the second half of 2015, even if inflation rises above the Fed's 2% target, as long as inflation remains in the vicinity of this target and expectations for higher prices stay anchored.

Outlook

As we head into the second half of the year, the U.S. economy continues to “inch along,” and we expect quarterly economic expansion of 3% or better for the remainder of the year. We also anticipate higher market interest rates by year-end, although the magnitude of the potential increase appears to be waning; the rate differential between U.S. versus European and other government holdings remains high by historical standards. This bolsters global capital flows toward the U.S. market, providing support for Treasuries. Moreover, as measures of economic activity begin to reach threshold levels that put the Fed closer to changes in policy, we should see interest-rate volatility increase.

In terms of portfolio positioning, astute selection among bonds with 5-10 year maturities has offered a combination of income and price appreciation as these issues progress toward maturity. This is because, assuming a positively sloped yield curve, bonds nearing maturity are valued at successively lower yields and potentially higher prices. As Fed policy eventually shifts, we expect the curve to continue flattening, with yields on short-dated bonds rising faster than those on long-dated issues.

Overall, in the current environment we view the opportunity cost of maintaining a more conservative posture is relatively low, as spreads (or the incremental yield of riskier bonds over U.S. Treasuries) have narrowed considerably, and rates are unlikely to move significantly lower. These narrow spreads, combined with geopolitical events or a possible equity market correction, could set the stage for a pullback in riskier fixed-income asset classes. Indeed, we have already seen spreads for high-yield bonds widen in July.

With bonds outperforming expectations since the beginning of 2014 (reflecting interest rate declines and narrower spreads), we expect only modest fixed-income returns in the second half of the year. Accordingly, we believe fixed-income investors will increasingly focus on yield, as the prospect of higher rates may hamper further price appreciation.



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