Market & Investment Insights

2014 Third Quarter Fixed-Income Market Review

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Article Highlights:

- The U.S. bond market delivered weaker though positive returns in the third quarter.
- Slowing global growth and geopolitical concerns made investors more risk-averse, driving increased demand for “safe” assets.
- Long-term Treasuries benefited the most from the quarter’s “flight to safety.”
- Short-term yields rose in anticipation the Federal Reserve will raise benchmark interest rates in the coming year.
- High-yield and emerging-markets debt were notable underperformers.
- Inflation-protected bonds also lost ground as inflation expectations declined.

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U.S. fixed-income markets delivered weaker overall returns in the third quarter of 2014 compared with the first two quarters. Amid a more risk-averse environment, investors favored safe-haven assets. Long-term Treasury bonds (maturities of 20 years or longer) were the market’s best performers, returning 3%. Meanwhile, short-term Treasuries, investment-grade corporate bonds, and structured instruments such as mortgage-backed and asset-backed securities realized flat to slightly negative returns, based on Barclays indexes. High-yield bonds and global emerging-markets debt were among the chief underperformers, returning -1.87% and -1.27%, respectively.

Markets were unsettled as the Federal Reserve wound down its quantitative easing (QE) asset purchases through the third quarter, ultimately concluding the QE program in October. Moreover, as the U.S. economy showed signs of improvement—with consistent employment growth, expanding manufacturing activity, and rising consumer confidence—short-term and intermediate-term interest rates rose on fears that this mounting strength could accelerate the Federal Reserve’s timetable to begin raising its target federal funds rate. Long-term yields fell, however, as global growth slowed, inflation was subdued, and simmering geopolitical conflicts in Ukraine and the Middle East drove investors to the relative safety and more attractive yields of long-term Treasury bonds.

The Barclays U.S. Aggregate Bond Index, a broad benchmark of investment-grade fixed-income performance, had a total return of 0.17% for the third quarter,

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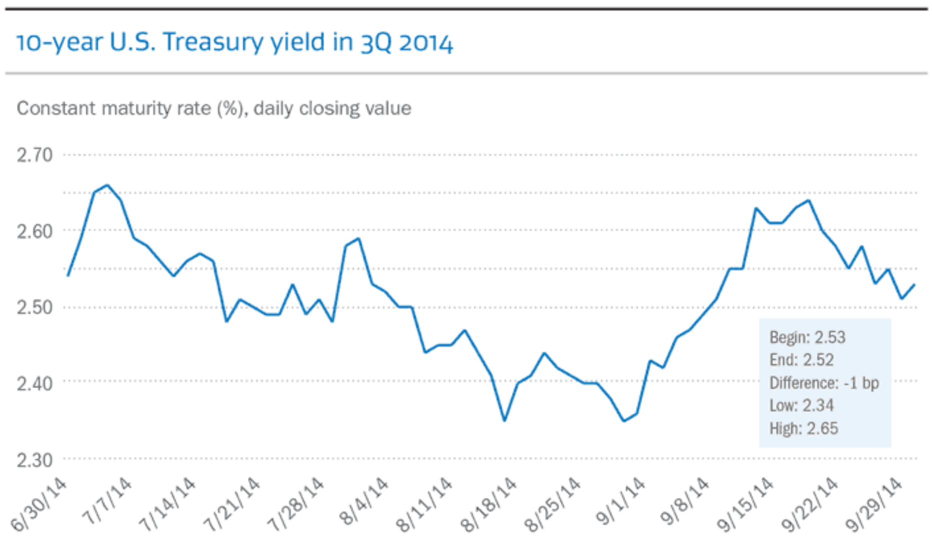
bringing its year-to-date return to 4.1% as of September 30, 2014. That compares with a 2.04% total return in the second quarter and 1.84% in the first.

The 10-Year Treasury yield finishes the quarter where it began

The 10-year Treasury yield—a benchmark for many other U.S. interest rates—began the quarter at 2.53% and jumped to a two-month high of 2.65% in the first few days of July. Economic reports showing strong employment growth in June (and upward revisions for April and May), as well as improved home and auto sales, raised concerns that the Federal Reserve might begin to raise interest rates earlier than the mid-2015 timeframe most economists had expected.

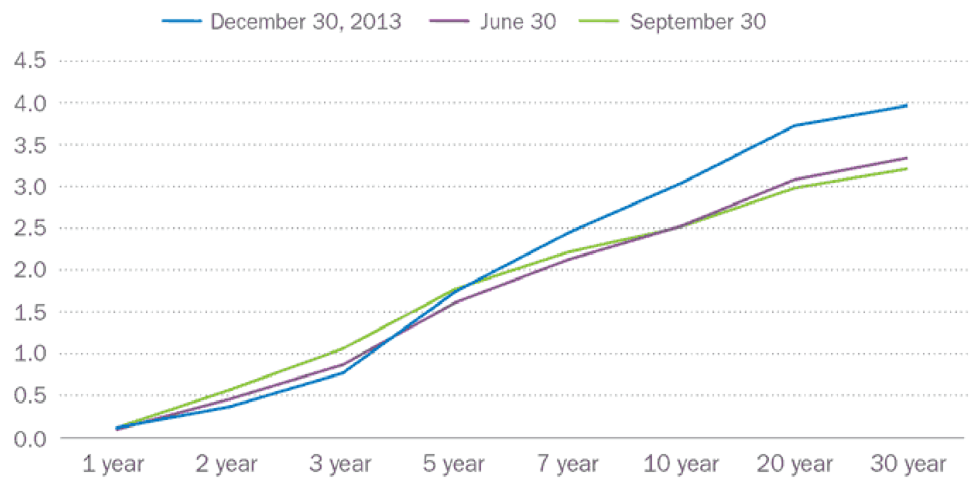
However, the spread of armed insurrection in parts of Iraq and Syria, the downing of a Malaysian passenger jet over eastern Ukraine and the resumption of violent conflict between Israel and Hamas fueled an environment of heightened risk aversion that benefited Treasuries and pushed the 10-year yield back down to 2.34% by mid-August. (Yields and prices move in opposite directions.) Those geopolitical conflicts stayed relatively contained, however, and by the end of September, the 10-year yield rose back to 2.52% amid further economic strengthening in employment, manufacturing and service-sector activity, construction spending, and auto sales.



Source: U.S. Treasury Department

With short-term and intermediate-term yields rising and long-term yields declining, the yield curve flattened in the third quarter.

Treasury yield curve



Source: U.S. Federal Reserve

Meanwhile, credit spreads, or the yield differential between riskier bonds and U.S. Treasuries, widened during the quarter. (When spreads widen, this generally indicates that investors are less comfortable taking on added risk without demanding a higher yield as compensation for that risk.) In this case, the widening reflected a general decrease in investor risk appetite rather than expectations of higher default rates for higher-yielding debt.

Investment-grade corporate bonds showed little change, returning -0.08% during the quarter. Within the corporate bond sector, utility bonds (0.45%) outperformed those issued by industrial (-0.16%) and financial services corporations (-0.05%). Returns were generally subdued for structured fixed-income categories as well, including mortgage-backed securities (+0.18%), asset-backed securities (0.01%), and commercial mortgage-backed securities (-0.23%).

Risk aversion hits high yield

After a nearly year-long streak of positive monthly returns, volatility returned to high-yield markets. Negative returns in July and September resulted in a decline of close to 2% for the full quarter, marking only the fourth time the broad high-yield market has posted a quarterly loss since 2008. The downturn was presaged by Federal Reserve Chair Janet Yellen's expressed concerns over elevated valuation levels for high-yield securities given their extended run of strong performance. A September surge in new high-yield issuance exacerbated conditions and proved difficult for the high-yield market to digest.

Emerging-markets debt (-1.27%) underperformed as the U.S. dollar rallied to a four-year high against major currencies on the relative strength of the U.S. economy and the anticipated rise in U.S. interest rates. U.S. Treasury Inflation-Protected Securities (TIPS) also struggled, returning -2.04%, as inflation expectations declined thanks to lower-than-expected gains in consumer prices (due in part to declining energy costs) and the strengthening U.S. dollar.

Municipal bonds, though not included in the Barclays Aggregate, produced positive returns for the third consecutive quarter, reflecting strong investor demand for tax-exempt income and a decline in new issuance. While new issue supply in the quarter was similar to that of the third quarter of 2013, it was 10% lower on a year-over-year basis for the nine months ended September 30. Demand for municipal bonds increased, with new issues frequently oversubscribed by five times or greater particularly for higher-coupon and longer-dated issues.

Outlook

For the U.S. economy, third-quarter GDP growth came in at 3.5%, though it may be revised downward. For the fourth quarter, we expect 3.5% growth again, as labor and production metrics appear to be on the same stable growth path they have been on for most of this year. Rising consumer confidence on the heels of falling gasoline prices should translate into a surge of consumer spending in the first half of 2015 and provide a tailwind to further employment growth.

We think the 10-year Treasury yield could rise to 2.5% by the end of this year. Meanwhile, U.S. growth is likely to accelerate marginally through next year, averaging close to 3.25% compared with an average of about 2.3% for 2014. If that occurs, we would expect the 10-year yield to climb a bit higher, but only to about 2.75% by the end of 2015. While U.S. yields are still low in absolute terms, they are attractive relative to government bond yields in Europe and Japan, where weak growth and low inflation remain a problem. As a result, strong global demand for longer-term Treasuries is likely to continue, helping to keep a lid on rate increases in this part of the yield curve, even as shorter-term rates come under pressure. For this reason, we expect the yield curve to stay in its relatively "flat" condition, or possibly flatten further, in 2015.

Overall, we believe U.S. fixed-income markets will benefit from both domestic and international flows as we enter 2015, given the likelihood of only modestly higher interest rates. The highest-risk fixed-income categories may be volatile leading up to the Federal Reserve's first move to raise interest rates, which we still expect to occur sometime close to midyear 2015. For additional analysis and perspective, read the summary of our most recent fixed-income webinar, "With the End of Quantitative Easing, the U.S. Enters Era of Rising Interest Rates."
