Market & Investment Insights

2014 First Quarter Fixed-Income Market Review

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Article Highlights:

- Declining interest rates helped U.S. Treasuries and the broad fixed-income market post gains after losing ground for 2013 as a whole.
- After significantly underperforming in 2013, emerging-market and municipal bonds led strong performance across fixed-income sectors to start the year.
- Yields on longer-term bonds dropped during the quarter, while those on shorter-dated securities rose, leading to a flatter yield curve.
- Bonds have outperformed expectations since the end of 2013, although they are unlikely to continue to do so as the year progresses.

Bonds begin 2014 on a high note

Most major bond-market indexes realized solidly positive returns in the first quarter of 2014, a somewhat unexpected outcome. Conventional wisdom at the start the year called for rising U.S. interest rates as the economy strengthened and the Federal Reserve began tapering its quantitative easing efforts. However, declining rates for intermediate- and longer-dated issues helped the broad-market Barclays U.S. Aggregate Bond Index gain 1.84% following a year in which it produced its first annual loss since 1999. Securities with maturities of 10 years or more returned 5.34%, far outpacing shorter-term bonds. Treasuries (+1.34%) and other lower-risk categories generally lagged higher-yielding sectors.

While economic growth was not strong enough to cause upward pressure on interest rates during the quarter, the relatively soft economic data and weather-related disruptions did not raise concerns over increasing defaults. Against this backdrop, demand for higher-yielding securities outstripped supply, driving outperformance of high-yield and investment-grade corporate bonds, which gained 2.98% and 2.94%, respectively. Emerging-market debt—last year's laggard among major fixed-income categories—was the first quarter's top performer, returning 3.67% amid declining interest rates and reduced worries over growth in China.

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Economic releases and the fear of higher interest rates influence the 10-year Treasury

The yield on the bellwether 10-year Treasury note declined during the quarter, with some periods of volatility (see Exhibit 1). After beginning the year at 3.04%—a 2 ½-year high—the 10-year yield fell 43 basis points (0.43%) to 2.61% during the quarter's first four weeks. A soft December jobs report, investor concern over heightened equity market volatility, worries about a slowdown in the emerging markets, and declining expectations for inflation were catalysts for the drop.

The 10-year yield rose to 2.80% in early March on the heels of a series of largely positive economic releases, but quickly fell back below 2.70%. Then, on March 19, in her first press conference as chair of the Federal Reserve, Janet Yellen suggested that the Fed could begin raising short-term interest rates "around six months" after the current tapering process ends—a time frame earlier than the markets had anticipated. Additionally, her remarks seemed to suggest a more aggressive path of interest-rate increases. These "hawkish" comments drove the 10-year yield back up to 2.78%. The market's swift reaction serves as a reminder of the Fed's influence, especially during a slower-than-normal economic recovery augmented by unprecedented monetary stimulus.

Exhibit 1

The 10-year Treasury yield fell 31 basis points in the first quarter

Source: U.S. Treasury data

The Treasury yield curve flattens

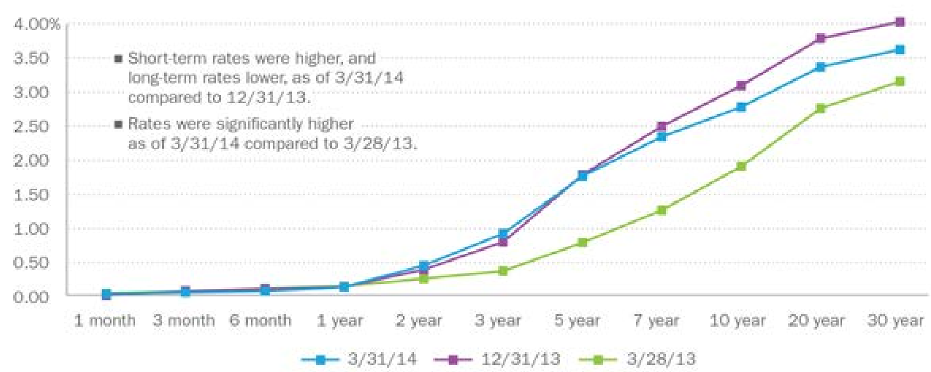
During the quarter, short-term rates rose modestly, while long-term rates declined. This shift caused the long end of the yield curve to "flatten" substantially (see Exhibit 2). Rates were significantly higher at the end of the first quarter than they were a year prior, with the greatest increases coming in bonds with maturities from 5 to 10 years.

The short end of the curve spiked immediately following Yellen's remarks as the market shifted expectations forward for the next Fed rate hike. The 2-year Treasury, for example, rose 11 basis points, and the 3-year, 16 basis points—their largest one-day increases since December 2010 and June 2009, respectively.

On the long end of the curve, yields for bonds with maturities of 20 and 30 years fell by 41 and 40 basis points, respectively, during the quarter. Yields were driven down by a number of factors, including a tame outlook for inflation, continued demand by pension plans and liability-driven investors, lingering supply constraints within certain interest-rate-sensitive sectors, and heightened expectations for accommodative monetary policy measures in Europe.

Exhibit 2

Treasury yield curve comparisons

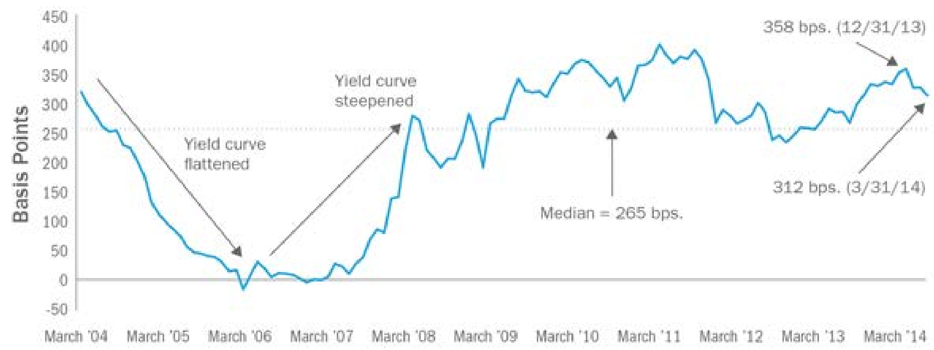


Source: U.S. Treasury data

Despite flattening, the yield curve remained steep, indicating that investors expect continued economic improvement. At quarter end, the difference in yields between 2-year and 30-year Treasuries was wider than the median difference between these yields from March 2004 to March 2014 (see Exhibit 3).

Exhibit 3

Difference in yield between the 2-year and 30-year Treasury



Source: Bloomberg

Fed maintains its dovish status quo

Yellen generally stuck to the playbook of her predecessor, Ben Bernanke. Although her unscripted “around six months” comment on March 19 worried markets, subsequent speeches and minutes from the Fed’s March meeting revealed a dovish central bank.

Furthermore, Yellen believes that gaps in the labor market might not narrow for another two years or so, and that inflation will stay contained during that period. Overall, the Fed mood is very tolerant of low interest rates, which should help contain increases in long-term Treasury rates and is a bullish signal for equity markets as well. Therefore, we anticipate that interest rates will remain at near-zero levels until the end of 2015 or early 2016.

In addition, we see the Fed maintaining its course of tapering, currently at $10 billion per month. The Fed believes the economy is progressing at about the right pace, and, in our view, there is a high bar to changing the current tapering path.

Outlook

Later this year, fixed-income markets will be exposed to the impact of rising interest rates as the U.S. economy finally puts the effects of the severe winter weather behind it, and GDP growth returns to the expected trend of 2.8% in the second quarter. A number of indicators point to a strengthening U.S. economy, including corporate profitability above its 2006 peak, the capacity for higher capital expenditures, and increased government spending, especially by the states. Furthermore, we believe that consumer deleveraging (or paying down debt) has largely played out, and we have seen a modest uptick in consumer credit metrics—often a precursor to significant economic expansion.

While we expect economic activity to pick up, our outlook for inflation remains muted given 1.5% headline inflation and 1.7% core inflation, which excludes volatile food and energy costs. We do not expect changes to this trend over the next 12-18 months.

In terms of portfolio positioning, astute security selection among bonds with maturities from 7 to 10 years offers a combination of income and price appreciation as they approach maturity if investors “roll down” the yield curve, which remains steep by historical standards. (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.”)

Additionally, spread sectors (higher-yielding, non-U.S. Treasury securities) should continue to hold up well, given low expected default rates and continued economic expansion. A shortage of supply in several spread-sector categories, including asset-backed securities and commercial mortgage-backed securities, will also help to support prices.

Careful security selection in emerging-market debt may also provide opportunities, especially among issuers that have demonstrated a measure of immunity to a slowdown in global growth. Within high-yield bonds, low yields and relatively narrow spreads versus historical averages make it challenging—though still possible—to find strong performers.

Overall, although bonds performed better than anticipated in the first quarter, they are likely to face headwinds and potentially greater volatility from rising interest rates as the year progresses. Such an environment should nonetheless offer pockets of investment opportunity, as drops in prices lead to compelling bond valuations on a selective basis.