

Investment Update



January 2011

Shades of 1994?

Over the last six weeks, yields on 10-year U.S. Treasuries rose by 100 basis points, or 1%. This move, while not unprecedented, was surprising for several reasons.

First, for much of 2010, bond yields remained very low, and, by early October, yields had dropped to just under 2.4% on fears of a double-dip recession and sustained deflation. Second, rapid rate changes traditionally have been accompanied by a shift toward a less accommodative monetary policy.

For example, in March 2004, the Fed tightened from a neutral/hold by hiking the fed funds rate, causing a 100-basis point rise in yields. Previously, in early 1994, the Fed shifted from a hold position to a tighter stance, sending 10-year Treasury rates up 125 basis points in 48 days. That rate increase set the tone for one of the worst years since the almost 30-year bond bull market began in 1982. In fact, 1994 ended with the 10-year Treasury down over 8%.

Could a similar experience be in store for us in 2011? We don't think so. While we believe that the multi-decade bond bull market is over, we do not think prospective conditions likely will produce steep losses.

Most of the upward adjustment in rates reflects improving economic data, waning concerns of another recession, reduced uncertainty following the mid-year election results and an improved tone toward business in general. In other words, the rate increase represents a re-normalization of rates, bringing them closer to the 4% range, where they were in April 2010 before we experienced a scare, albeit temporary, of weakened growth.

Treasury Yields — A Bumpy Road

10-Year Constant Maturity Treasury Note Yields



As of 12/27/10. Source: Bloomberg LP

While growth has continued to improve, we do not think that GDP growth will be sufficient to generate significant near-term inflationary pressure. While the tax cuts and unemployment extensions will further widen the deficit, they will not change the budget deficit's long-term trajectory, which remains a significant, imminent concern.

Also, despite our seemingly well-placed cynicism about the deficit reduction commission report and the response since its release (which has been about what we expected), the possibility remains that some meaningful first steps will be taken to address the deficit and possibly simplify tax policy. Some degree of real progress could help reduce upward pressure on rates. As such, while we do expect rates to move higher over time, we do not expect 2011 to represent a major sea change. Investors may look at the recent rise as a wake-up call that the trend of ever lower long-term rates likely is behind us.

Several times last year, we cautioned against the continued strong inflows into bond mutual funds because we felt that rates were at inappropriately low levels. In 2011, we continue to recommend a below average exposure to fixed income, but our recommendation more reflects the opportunity we see in equities than an expectation of much higher rates. We do not think that rates will rise significantly enough to become headwinds to equities — at least until economic growth further accelerates and thus increases the risk of inflation.

Advice from Experts

In light of his role in crafting the Fed's initial response to the financial crisis, we have great respect for Ben Bernanke. However, we have been dismayed to see him hold forth on prime time television recently. While his efforts to ensure clarity and transparency are laudable, from our experience the sound bite-oriented format of TV is not well suited to the complicated task of communicating central bank policy. It becomes far too easy for armchair chairmen and economic comedians — a rare breed indeed — to cause embarrassment by pointing out seeming or actual contradictions between comments from prior appearances and more recent ones. We feel these appearances diminish the credibility of the Fed and do nothing to quell the considerable internal debate over the efficacy and advisability of ongoing quantitative easing.

At one point during his recent *60 Minutes* appearance, Chairman Bernanke responded to a question about his degree of confidence that raising rates will control inflation by saying, "One hundred percent." While we want our policymakers to be certain of their actions, this comment was disconcerting in light of his prior expressions of confidence around numerous housing-related issues.

For example, consider Bernanke's comment from a July 1, 2005 CNBC interview: "We've never had a decline in housing prices on a nationwide basis. What I think is more likely is that house prices will slow, maybe stabilize.... I don't think it's going to drive the economy too far from its full-employment path, though." At another time, he expressed his feeling that the sub-prime mortgage crisis would remain contained. While we know experts can fall into the same traps as everyone else, we would prefer to see them preserve some semblance of great and infallible wisdom rather than reveal their all-to-human shortfalls for the world to see.

Another example of these transgressions also aired on *60 Minutes* recently. An analyst created quite a stir when she predicted that there would be 50 to 100 significant municipal defaults in 2011. Immediately, investors began

selling municipal bonds, some questioning whether they should own any such bonds at all. In reality, the precarious state of municipal finances is not a new story and is well understood by most professional investors in this space.

Looking Ahead

While some municipalities will default, we feel that far fewer than the number this "expert" predicted will fall into such dire straits. Further, debt levels for most local and state governments are relatively low, and debt service is a small portion of most municipal budgets. All considered, we feel that forgoing payment on what would represent such a small savings would not solve a budget problem and would create far greater future financing struggles.

While being armed with such insights does not insure immunity from difficulties, well-prepared investors will do their homework and select bonds they understand and believe will be able to meet their debt obligations. After all, we are again able to find bonds we think are stable at yields that compare very favorably to Treasuries and other taxable bonds. While caution is warranted and some areas should be avoided, outright selling does not appear appropriate.



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