THE OMNIVEST MARKET VIEW

Investments

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Can 2011 be Worse for Bonds than 1994?

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Fixed income investors that lived through the 1994 bear bond market remember that it was the worst year for fixed income investors. During that year, every fixed income sector suffered from negative price movements, with the 30-year Treasury bond market losing 18% of its principal value. While coupon income was able to offset principal loss, it was not sufficient to offset all of the losses. Hence, fixed income investors suffered total return losses for all of 1994. For example, investors lost 3.35% in the Treasury market while investment corporate grade investors lost 3.34% and the Municipal market had a total return loss of 6.18%.

In 1994, interest rates soared across all fixed income markets as the Federal Reserve embarked on a monetary tightening campaign after having kept interest rates unchanged from September 4, 1992 to February 3, 1994 at 3%. In reaction to the Federal Reserve raising interest rates, bond investors began to sell their fixed income investments, which in turn, pushed market yields substantially higher.

During 1994, yields on the 2-year Treasury note rose by 350bps, yields on the 5-year Treasury note rose by 266bps and yields on the 10-year Treasury notes rose by 210 bps. Accordingly, investors who did not recognize the shift in monetary policy were subjected to total return losses.

While 1994 was dubbed as the worst year for fixed income investors, we believe that the next twelve months could be even worse. In the table (below), we compare the actual returns from the Treasury coupon curve in 1994 with the expected returns for the same maturity range over the next twelve months. In order to demonstrate how much more vulnerable the fixed income investor is today versus 1994, we shift interest by the exact same amount that occurred in the previous bear market.

There are several factors that could act to punish fixed income investors more severely during this cycle than in the past.

Our deficit as a percent of GDP is hovering around 9% versus only 2.6% in 1994. During the previous cycle, the Federal Funds rate was kept at 3% for 17 months while in this cycle, the Federal Funds rate has been at 0% for the past 26 months. It is our contention that the past 26 months of extreme monetary ease has created a much more complacent environment for fixed income investors.

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Finally, the search for yield has likely exacerbated the fair market value of interest rates and has further been distorted by the purchase of Treasury notes and mortgages by the Federal Reserve over the past 2 years. As a consequence, once investors begin to sense a shift in monetary policy, they will be forced to liquidate their fixed income assets at extraordinarily low yield levels without sufficient income to offset price erosion. 1994 just may end up looking like a cake walk.

	12/31/93 - 12/31/94		
	Total Return (%)	Yield Change (bps)	12 month Projected Returns (%)
2-Yr Tsy	0.255	3.4910	-2.52
3-Yr Tsy	-1.521	3.3077	-4.81
5-Yr Tsy	-4.264	2.6655	-7.33
10-Yr Tsy	-8.292	2.0809	-11.32
30- Yr Tsy	-11.988	1.5714	-16.91

Source: *Bloomberg (12/31/93 - 12/31/94*

About OnmiVest Group LLC
OmniVest provides strategic guidance on the economic and market trends that affect the performance of clients' portfolios. With an experienced team and a global perspective, OmniVest Group translates market information into actionable ideas that we can leverage to meet client's goals.

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