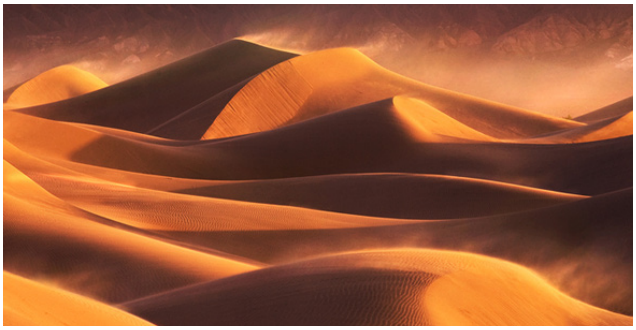
FirstPoint Financial

WEEKLY MARKET THOUGHTS

May 16, 2014

Shifting Sands – Revisited

Early last year, we created a three-part thought piece on the potential for rising interest rates. Because it has been more than a year since this discussion, we thought it appropriate to revisit the issue and perhaps provide a new twist on this very important, long-term investment theme. When we wrote the piece last year, the 10-year U.S. Treasury Bond was yielding 1.62%. Today, that bond is yielding 2.63%, a rise in rates of a little more than 1%. While this doesn't seem to be a significant issue, if an investor had purchased the 10-year Treasury at the time of our original writing, the total return the investor would have experienced to date (interest less price decline of the bond) would have been -7.1%. A poor return for a supposedly "safe" investment. Let's revisit the Shifting Sands theme.



Shifting Sands – The Meaning

Our Shifting Sands theme refers to the inability for one to gain solid footing while standing on unsteady ground. Let me explain. Interest rates (as measured by the 10-year U.S. Treasury Bond) declined from a high of 15.84% in September of 1981 to a low of 1.46% at the end of July 2012 (please see chart below). Over this same period of time, inflation declined from more than 10% per year to less than 1% on an annualized basis.

Interest Rates are Low World-Wide

Interest rates, world-wide, are low in relation to inflation. "Real" interest rates (interest rates after inflation) are barely positive world-wide. In other words, the markets believe so thoroughly in the sustainability of low inflation pressure that multi-year investment decisions are now being made, with bets on sustained low inflation pressure as far as the eye can see.

Low Rates Forever!

While we cannot point to an exact major catalyst as to when interest rates will rise, we believe the real question regarding rising rates is not so much a matter of if rates will eventually rise but rather when. Wall Street is littered with misplaced calls of rising interest rates. We are not calling for rates to rise, at least not dramatically, in the immediate future. But, we are suggesting that the probability is high that, over the next one- to three-year period, interest rates could rise.

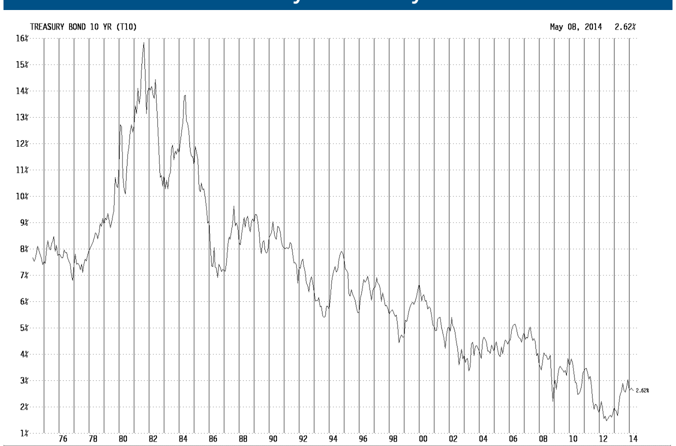
Shifting Sands

While our feet seem to be firmly planted in an extremely low interest rate environment, driven by seemingly endless largesse of major central banking activities, we enjoy bond prices that seem very stable. Bonds are assets that investors have purchased historically for three purposes:

1. **They bring stability** – Bond return volatility has been low in relation to many other asset classes.
2. **They bring income** – Historically, bonds have provided a high income flow – normally well above underlying inflation trends.
3. **They bring liquidity** – Most bond classes can be easily purchased or sold. They rank among the world's most liquid assets.

We suggest bond returns will eventually be systemically different in two ways than in the past. First, returns will be lower than historically has been the case, in absolute and real terms. Second, if we are correct that eventually rates will continue to rise, the volatility of bond returns will be much higher than has been the case over the last number of decades. As can be seen from the chart below, interest rates have been declining for the last 32 years. If this trend were to change, a wise bond investor must understand the risks faced in that type of environment.

Treasury Bond - 10-year



Are We Wrong?

What if we are wrong and inflation/interest rates don't eventually rise. What then? Are we making a bad call by advising investors to reconsider their traditional use of bonds in portfolios? If inflation and interest rates don't eventually rise, will investors make good returns in bonds?

If an investor purchases a "AA" rated General Obligation bond today, generic market information tells us that the yield on an average five-year high quality bond is currently at 1.6%, tax free (at the Federal level). If this bond is purchased, it is a mathematical certainty that the holder of this bond will earn 1.6% on their money annually over the next five-year period.

In addition, unless an individual investor is strong at credit analytics, he or she needs to hire a manager to oversee the portfolio, and pay the manager a fee. In this case, let's assume a management fee of 0.5% annually. Over the last 12 months, according to the Bureau of Labor Statistics, inflation has risen by 1.5% (all items CPI). If inflation remains the same and does not rise from these very low levels, the investor in our example makes an annual return of -0.4% per year, after inflation and fees on the investment.

To an investor who is interested in actually growing his or her wealth by a reasonable amount, a net after-inflation, after-tax return of -0.4% per year is not acceptable. Again, there is no real speculation involved in this expected return. If inflation simply stays at current levels, the poor return is a mathematical certainty.

If inflation and interest rates rise in the future, the investor who has locked in a return of 1.6% tax-free will be even further behind. Consequently, we stand by our original view that even with a "buy and hold" strategy, reasonable returns may not currently be available in the core bond markets.

The only serious economic scenario where buying long-term bonds makes investment sense (for most investors) is a scenario where the world's economy moves into a serious growth contraction. Is this possible? Sure. But at this time, the bulk of the indicators that we monitor suggest the probability of a global economic contraction occurring over the next 12 months to be rather remote.

Where to Turn

We advise investors to have a serious conversation with their Wealth Advisor on a strategy designed to meet their fixed-income needs. The purpose of this outline is to highlight that even without a rise in interest rates, investors need to consider alternatives to their typical bond strategies which have served them well over the last 30+ year period of time.

We can think of few variables which have the potential of defining investment opportunities over the long term more than inflation pressures and resulting interest rates. We sense the sand shifting beneath our feet – and we fear the tremor is higher interest and inflation rates in our long-term future.

Investors need to consider various forms of risk when making all investments – bond investments included. Two major risks bond investors face is "duration" risk (the exposure in principal the bond position holds to a shift in interest rates) and "default" risk (the risk of not getting one's money back upon maturity). We currently believe duration risk carries sharper "teeth" than the risk of default, in general. In other words, in many cases, we are less willing to extend maturities in clients' portfolios than take on a measured decrease in credit quality.

The sands are shifting beneath our feet.
We will be back next week.

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