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Bond Market Commentary

A Flatter Yield Curve: The Case to Hold Longer Dated Bonds

While many expect a pick-up in U.S. economic activity in the second half of this year, Treasury rates remain low. This is a challenge for bearish bond investors who believe 2014 is the year of much higher yields. Less than a decade ago, under Chairman Greenspan (May 2004 – February 2006), a similar event occurred with a tightening of monetary policy. This is similar of today, where the Fed has indicated that the Federal Funds rate could begin to rise in the next couple of years which the Treasury market has moderately anticipated starting last year. In reviewing the chart of the yield curve comparison between 5/31/04 and 2/28/06 (page 2), we can see that 3 month bills increased by 355.6 bps and the five-year note increased by 80.8 bps yet the 30 year bond fell by 83.7 bps.

Today, many in the bond market are shaking their heads when they look at the next chart of the yield curve comparison between 12/31/13 and 4/30/14 (page 2), which shows the 10 year note yielding 2.65% down from 3.029% at the start of January. Other sections of the U.S. Treasury market have also performed strongly since the year began; long-term Treasuries with a maturity of more than 25 years have delivered a total return of 10.09 percent in 2014 as per Barclay's indices.

It appears likely that if a stronger economy (and not a second quarter rebound from a slow first quarter) stands to push bond yields higher, such a move will be led by shorter maturity Treasuries and not the long-end. Moribund inflation also supports the case for holding longer dated bonds. Additionally, the message from the Treasury market stands at odds with the consensus call of a sharp rebound in the economy over the coming months. Low bond yields and inflation suggest an economy still deleveraging after the bursting of the housing and credit bubbles. [Compounding this, the economic models used by the Fed, incorporate data from the previous era of secular credit expansion, which makes them fraught with huge error terms]. In short, a very tenuous recovery of the economic patient that has been contingent on massive and frequent doses of monetary stimulus and intervention will now be exposed to premature removal of the oxygen mask. The outlook of weakness for the economic patient implies slower growth and lower inflation, which should provide a favorable prospect for lower yields on longer maturity Treasuries.

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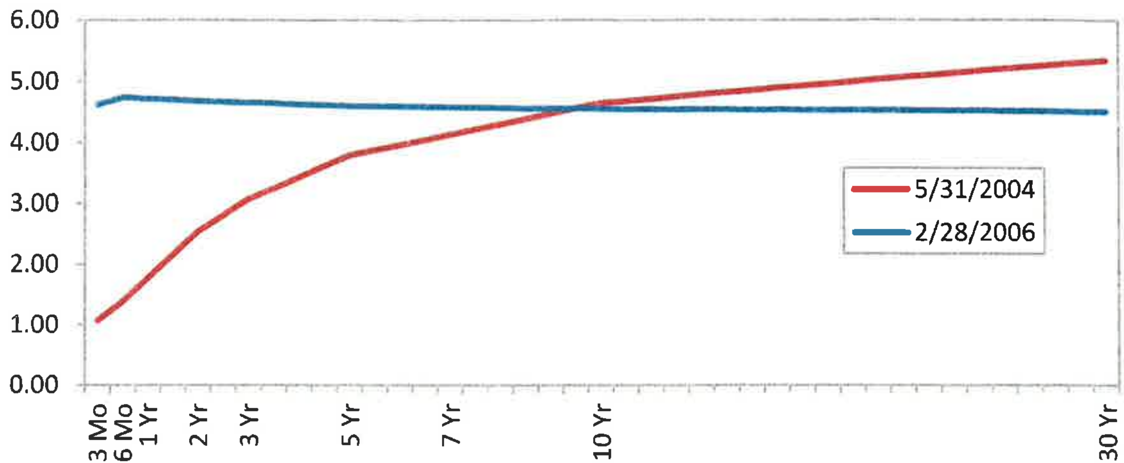

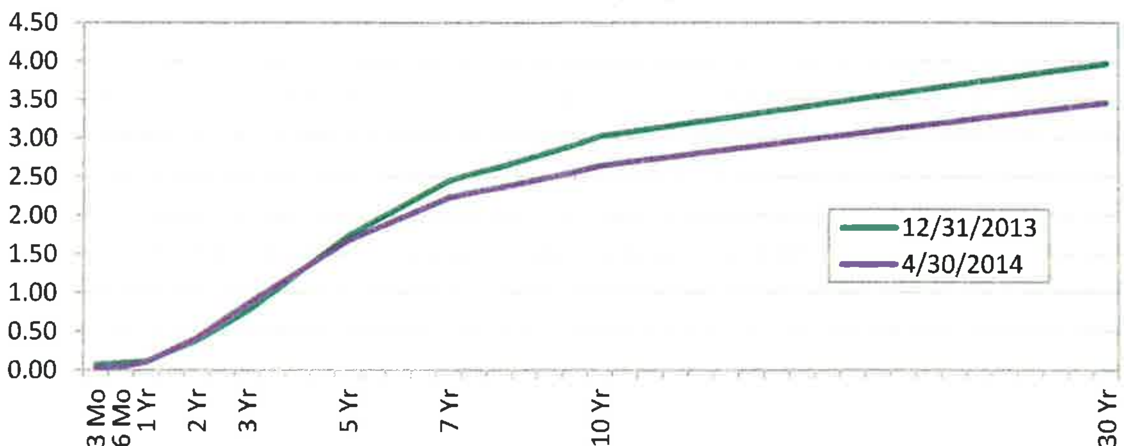

					Basis Point Change	
	5/31/2004	2/28/2006	12/31/2013	4/30/2014	***5/31/04 to 2/28/06***	***12/31/13 to 4/30/14***
3 Month	1.07	4.62	0.07	0.03	*356*	*-4*
6 Month	1.38	4.74	0.09	0.04	*336*	*-5*
1 Year	1.77	4.72	0.11	0.10	*295*	*-1*
2 Year	2.54	4.68	0.38	0.41	*214*	*3*
3 Year	3.07	4.66	0.77	0.85	*159*	*9*
5 Year	3.79	4.60	1.74	1.68	*81*	*-7*
7 Year	4.14	4.58	2.45	2.23	*45*	*-22*
10 Year	4.65	4.55	3.03	2.65	*-10*	*-38*
30 Year	5.35	4.51	3.97	3.46	*-84*	*-51*
3m – 30yr. Spread (bps.)	428	-11	390	343		

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