WEALTHMANAGEMENT DEC. 2014

EXIT BONDS, NOT SO FAST

The $11.7 trillion Treasury market is betting on history not repeating itself as the Federal Reserve moves closer to reducing its QE stimulus program.

From indications and pricing in the futures and derivatives markets, traders do not see the central bank raising its benchmark interest rate from its current record low until nine months after policymakers end their $85 Billion monthly bond purchases. This could mean we would not see our first rate increase until mid to late 2015. To show how sentiment has changed in recent months, in September 2013, when the Treasury market was tumbling in the midst of its worst year since 2009, the projected gap was two months.
The Fed's assertion that the tapering of its quantitative easing doesn't mean a tightening of monetary policy is starting to sink in among bond traders and portfolio managers. Sure, it may have an organic effect and we anticipate rates rising after any announcement in the diminishing of the QE program. But understanding that the end of QE does not signal and immediate rate increase may help contain yields as we move through 2014.

On May 22, when Fed Chairman Ben S. Bernanke first discussed ending purchases, "there was a consensus opinion that, 'Oh my God, this is the end,'" and that an increase to the federal funds rate would "be right on the heels of that last purchase," said Gregory Whiteley, who manages government debt investments at DoubleLine Capital, which oversees $53 billion. "That is not the consensus any longer," he said Nov. 19.

Treasuries have returned 0.62% since the start of September, after losing 3.95% the previous four months. Yields on 10-year notes — a benchmark for everything from corporate bonds to mortgages — have fallen to 2.74%, from 3% on Sept. 6, which was the highest since July 2011.

CHANGE IN SENTIMENT

The losses were sparked by Mr. Bernanke's now famous comments in May 2013 that policymakers "could take a step down in our pace of purchases" in the "next few meetings." After Mr. Bernanke's May comments, 10-year note yields steadily climbed up from 1.61% on May 1 to 2.75% on august 1st. The selloff in bonds rippled across the world, with companies slowing bond sales and emerging markets tumbling amid concern that there will be less cash floating around the financial system to invest in riskier assets.

In our opinion, tapering is not a tightening, rather it's just a slowing down of the easing. Once the first tapering happens, and the market sees it's small, the 10-year yield will likely go back to what is a more normal level in the low 3% range. That's now a view shared by many of the world's biggest bond fund managers, traders and analysts. This same group is now thinking that yields will see its peak around 3.5% into 2015, even with the Fed beginning to trim asset purchases as soon as the 1st quarter of 2014.

Yields on 10-year Treasuries have risen from 2.65% on November 1st to 2.81% on December 2nd. To put this move in historical perspective 10-year yields have averaged 2.66% since December 2008 and 3.51% the last decade.

Minutes of the Oct. 29-30 Federal Open Market Committee meeting, released Nov. 20, showed that Fed officials expected to reduce their purchases "in coming months" as the economy improves. Assuming that tapering begins in March, as forecast by Barclays among others, the firm expects the central bank will slow purchases over the course of the next six months, ending them in September 2014.
Implied yields on federal funds futures traded at the CME Group exchange signaled on Sept. 5 that traders saw a 64% chance the Fed would begin lifting its target rate, which has ranged from zero to 0.25% since December 2008, in December 2014. That probability has tumbled to 8.8% in recent weeks. Quite a significant change in trader sentiment, but always subject to change.

Sentiment changed after the FOMC meeting Sept. 17-18, when the central bank surprised investors by not announcing a tapering of purchases. Before then, as previously stated, the market was pricing a two-month gap between the end of tapering and the first rate increase, compared with nine months now, according to a Barclays trader.

Forward markets for overnight index swaps, which show what the effective federal funds rate will average over the life of the contract, suggest traders don't expect the Fed to begin raising rate until the second half of 2015.

That's the message the Fed has been trying to communicate. Janet Yellen, President Barack Obama's nominee to succeed Bernanke, won't remove stimulus too soon, even as the Fed's bond buying comes to a close, she said Nov. 14 in Senate testimony. "The message we want to send is that we will do what is in our power to assure a robust recovery in the context of price stability," Ms. Yellen said.

OUR VIEW

The markets generally expect tapering in the coming months and the markets have concluded that tapering will have a modest but measurable effect to the yield curve and to risk assets. But with few investors having made significant changes to their bond holdings in anticipation of the Fed's reduction in purchases, many are gripped by the fact we know it's coming but record highs in the equity markets have many just as concerned. To many conservative investors a 1% hit in bond prices is better than a 5-10% sell-off in the equity markets. It's sort of "been there, done that"

Most professional fixed income managers have focused on buying higher-rated credits and shortening their yield curve exposure to bonds down into the four to ten year range. These moves will have a profound effect on already anemic portfolio yields as managers seek out higher grade paper and shorten maturities compared to the last several years.

At WT Wealth Management we are staying the course in the Strategic Allocation part of our portfolios with continued fixed income exposure based on the clients overall risk tolerance but in the Tactical Allocation portion of our portfolios we will use inverse ETF's on the longer part of the curve to hedge our positions and provide greater portfolio stability as rates organically rise throughout 2014. These allocation will be monitored monthly based on current economic date and risk reward modeling.

Considering the most recent economic data which consisted of; continued reduction in unemployment, a 5 month high in Consumer Sentiment and stronger than expected 3rd quarter GDP we expect slow and consistent improvement of the economy which ultimately will lead to the reduction in the quantitative easing program resulting in 10-year treasury yields approaching 3.5% by year end 2014. With the clear and transparent signal that the Federal Reserve is providing we anticipate a smooth and orderly increase in rates without any late inning surprises. Understanding why you have bonds in your portfolio is the first step to developing a game plan for the next 12-18 months.

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