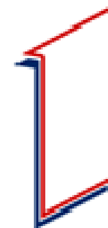
Bond Market Update

As of March 31, 2015 / Volume 4, Issue 1 / FFTAM.COM



The first quarter of 2015 for the fixed income market was somewhat eventful. Returns were positive, the economy downshifted, the Fed continued to entertain the idea of raising cash rates, Europe started its version of QE (Quantitative Easing) and the AAA yield curves, both taxable and tax-exempt, flattened.

Total returns for taxable and tax-free investments were positive. For the quarter, the Barclays Aggregate Bond Index recorded a total return of 1.60% and the Barclays Muni Index recorded a total return of 1.0%. From an economic standpoint, the economy faced some challenges in the first quarter. The inclement weather, port standoff in California, and the strong US dollar all created headwinds. Estimates for first quarter GDP have been moving down and now average a growth rate of 1.60%. ISM Manufacturing and ISM Nonmanufacturing continued their reading above 50 (a reading above 50 indicates expansion). The unemployment rate dropped to 5.5% from 5.6%, however, the FED did indicate that this will need to go lower to increase the prospects for inflation. The FED also acknowledged that the inclement weather and port shutdown are temporary and a rebound in economic activity in future quarters should be expected

The US Dollar appreciated significantly versus the other major currencies in the first quarter. This strengthening, in effect, qualifies as a tightening of monetary policy. Some reasons for the significant appreciation include the start of QE by Europe and the indication by the FED that they will embark upon the process of removing excessive accommodation. At the March 2015 FOMC meeting, the FED dropped the word “patient” from its statement which opened the door for them to start the process of raising rates at upcoming meetings.

Below to the left is the US Treasury Yield curve as of 12/31/14 and 03/31/15. As you will see, the yield curve flattened as intermediate to longer rates moved down. Below to the right is the AAA Municipal Yield as of 12/31/14 and 03/31/15. Its move is very similar to the US Treasury curve.

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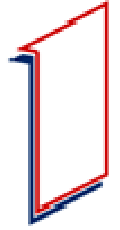

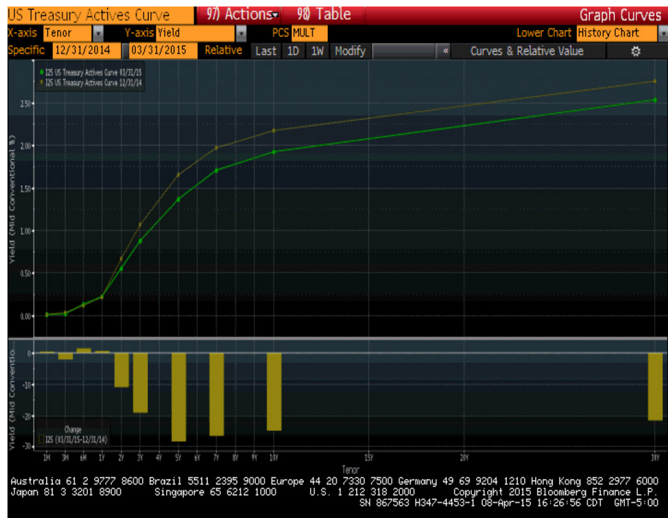

As with both curves, the flattening occurred because of the market's expectation that the FED will come into play in the near future by increasing the Fed funds target rate (the short end of the yield curve), and the market adjusting yields across various maturities along that part of the yield curve. The market also factored in lower future inflation expectations (affecting the intermediate-to-long end of the yield curve) resulting from the strong US Dollar and steep decline in the price of oil.

For the quarter, investment grade credit spreads were little changed and high yield ("junk bond") spreads tightened marginally versus the risk free rate.

Looking forward, we will continue to deploy that same strategy from previous quarters. In short, we remain committed to a very high credit quality portfolio with a slight bias towards flat to lower interest rates. It is important to note that the levels of interest rates around the world are lower than here in the US. That fact in conjunction with a FED that may come into play (with the market expectation of a very modest pace of the FED increasing the funds target rate) is causing us to buy bonds with maturity characteristics that result in our bond portfolios being slightly longer than our representative indices. We believe that longer-term yields will remain fairly stable which will allow us to capture a benefit from our active bond management of "the roll."

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