

Investment Update



May 2010

A New Direction

Intermediate and longer maturity Treasury bond yields have risen steadily since the financial crisis of late 2008, when credit markets reached their lowest point. As seen in the chart below, 10-year Treasury bond yields neared 4% in late March of this year, up from crisis lows near 2%, causing some investors to fear that inflation might be reigniting after a long slumber. While yields most likely hit a multi-year low during the worst of the crisis and probably will rise over time, we believe that the recent move in yield mainly reflects other, more benign, drivers rather than nascent inflation.

Treasury Yields Near Historic Lows

10-Year Constant Maturity Treasury Note Yields



As of 4/23/10. Source: Ned Davis

In late 2008, tremendous uncertainty and fear resulting from the financial crisis caused great demand for liquidity and the perceived safety investors felt treasury securities offered. This demand pushed yields far below levels that we felt were appropriate. When 10-year Treasury yields fell to just above 2%, we cautioned that investors were not being adequately compensated, given the prospect that inflation could return to average or above average levels over the next 10 years. As a result, we reduced our recommended exposure to intermediate and longer maturity Treasury bonds in favor of TIPS (Treasury Inflation Protected Securities), municipal bonds, high-quality corporate bonds and other investments that we felt offered more attractive risk-adjusted return prospects.

With the economy stabilizing and now beginning to improve, investors have moved away from this "safety-at-any-cost" stance. Rather than reflecting near-term inflation fears, we believe that the yield increase indicates investors' view that economic conditions have improved and a sustainable recovery has ensued.

Despite being higher than they were during the depths of the crisis, yields on intermediate- and long-term Treasuries are still low by historical standards. We expect that rates will rise modestly rather than quickly, as the economic recovery should be muted enough that excess capacity and high unemployment likely will diminish only gradually. This subdued activity should help keep inflation in check for some time. Therefore, the rise in real yields likely will reflect the improving global economic picture rather than warn of impending inflation.

Three's A Crowd

We always consider possible risks to our forecasts. In the rate area, an economic expansion that is more vigorous than anticipated could raise rates and rekindle inflation. Of greater concern is the increased supply of Treasury securities required to finance the seemingly insatiable desire to spend by the federal government. Where is all of this issuance coming from?

We previously have mentioned private deleveraging by individuals and companies; this trend has very much been in effect. According to the ISI Group, in four out of the last five quarters, the private sector has been shrinking its debt. This has not happened in the nearly 60 years that the government has been compiling this data! Without the fiscal stimulus supported by Treasury issuance, the GDP likely would not have grown over the last two quarters while the rest of the economy continued to delever. We will leave the discussion about the effectiveness and advisability of government deficit spending for another day, as it is lengthy and complex. The question for today is what will be the impact of the soaring issuance of Treasury securities?

Currently, demand from individuals and financial companies seeking strong reserve assets remains high enough to absorb the increased issuance. However, signs are increasing that both foreign and domestic investors are beginning to reduce their bond purchases. Countries such as China are moving toward becoming net sellers of Treasuries. This would reduce demand and put upward pressure on rates, necessitating the Treasury to offer higher rates to attract increasingly reticent buyers.

Some economists argue that higher rates would “crowd out” private borrowing because an increase in government demand will drive up real interest rates, causing banks to

respond by supplying a greater quantity of funds to the government. Higher rates eventually will be self-defeating. In addition to reducing private borrowing and possibly depressing growth, higher interest rates also would increase the cost of financing the growing deficit.

Recently announced tax increases and the likely expiration of the Bush tax cuts will be used to fund health care expansion rather than to address structural budget deficit reduction, necessitating other measures to pay for these increased costs, such as further tax increases. To us, these incremental burdens will act as headwinds and impede economic growth. They probably will not derail the recovery, but they should keep a yield increase in check.

Tipping Point?

At what point might higher yields become negative for equities? Certainly the Fed has gone out of its way to indicate that it would like to keep short-term rates very low for some time to come. The combination of very low short-term rates combined with moderately higher longer-term rates should support equity markets. Rates have not moved nearly high enough to compete with equities or risk stunting budding economic growth by cutting profits.

At this juncture, the main risk to equities is the weight of their prior success. As stock prices have increased, investor sentiment has climbed. It will be more difficult to engender positive surprises from this point forward. In fact, based on historical comparisons of previous market advances, a correction would not be unprecedented. Even a modest reduction in the desire to hold riskier assets could precipitate such a correction.

No shortage of worries exists in the minds of investors today; a prime example is the situation with Greece and the EU. Risk aversion stemming from contagion related to debt default or an exit from the EU, although unlikely, could certainly instigate a decline. Still, given the strong profit growth that we have seen and expect to continue into 2011, along with low short-term rates, reasonable valuations for quality stocks and remaining high levels of cash on the sidelines, we think that any correction would likely be modest. Furthermore, we believe that the intermediate-term direction for equities remains higher — current worries and clouds on the horizon notwithstanding.



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