Lynx
Investment Advisory

New Lessons in Bond Investing: Why yields are going lower and what should an investor do?

The Fed's recent announcement of the end of Quantitative Easing (QE), and the stock market marking recent highs would lead one to believe that withdrawing such massive stimulus would cause bond yields to go up. So why are they going down?

We believe there are two reasons for this contradiction:

First, the combination of an economic slowdown in Europe, fear of deflation, and the potential for a significant amount of European stimulus, has brought rates down in Europe. Figure 1 compares Spanish and Italian 5 year yields to 5 year yields in the U.S. European yields are lower than those in the U.S. despite the fact that Spain and Italy, until recently, were on the verge of a default scenario, given that their sluggish economies were hindered by large debt burdens. Consequently there has been an increased demand for U.S. paper given these yield differentials, containing U.S. yields despite the Fed's plan to end the bond buying program. This situation has provided us with our first new lesson in bond investing: *Don't let local market dynamics dominate your analysis; the world is interconnected and so is the search for yield.* The search for yield overseas eventually leads to demand for U.S. bonds as the markets correct interest rate differentials; Spanish and Italian bonds should yield more, not less, than U.S. Treasuries. With spreads across normally higher yielding bond sectors are at record lows, high yield is not high enough (see Figure 2).

Figure 1

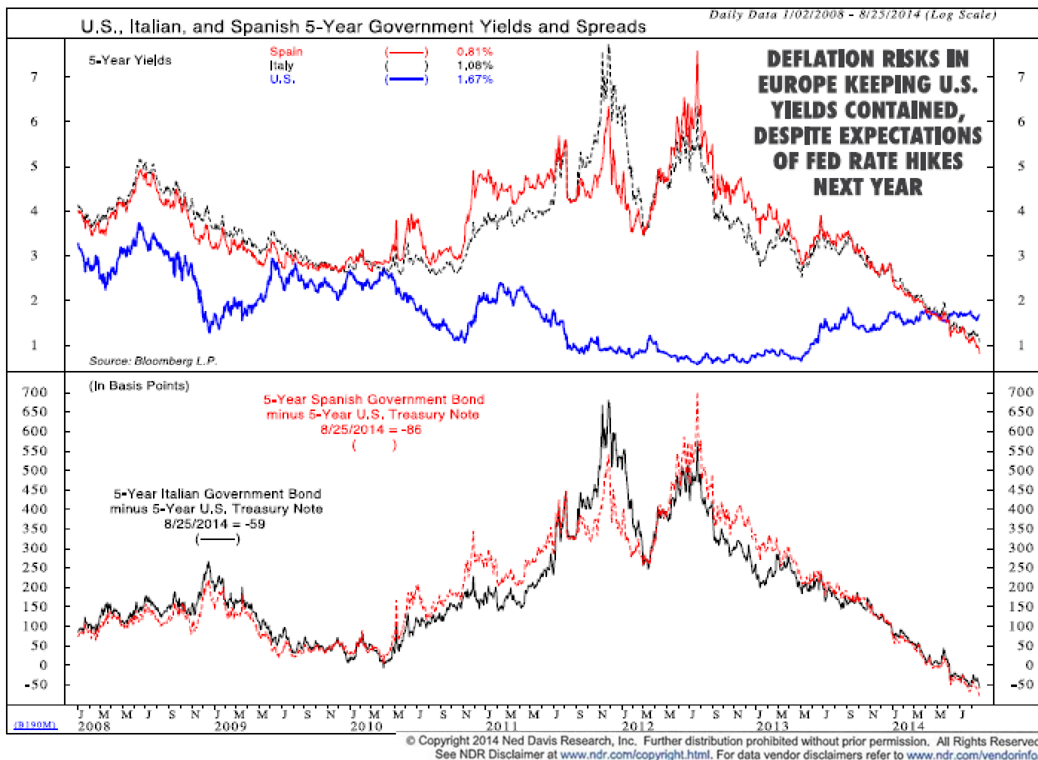

Figure 2

Lynx Investment Advisory

OAS for Components of Barclays U.S. Universal Index

Daily Data 8/01/2007 - 9/18/2014

OAS = Option-Adjusted Spread (in basis points)

U.S. High Yield

Emerging Markets (Blended Model Spread)

Commercial Mortgage-Backed Securities

Asset-Backed Securities

(B384E)

© Copyright 2014 Ned Davis Research, Inc. Further distribution prohibited without prior permission. All Rights Reserved.
See NDR Disclaimer at www.ndr.com/copyright.html. For data vendor disclaimers refer to www.ndr.com/vendorinfo/.

Second, concerns associated with the geopolitical risk in Ukraine, Iraq, Syria and the Gaza Strip continue to fuel demand for U.S. bonds. The Chinese, Japanese and OPEC countries continue to buy U.S. Treasuries despite low yields. According to U.S. Treasury data, the percentage of U.S. debt held by foreigners rose to 34% as of April, 2014 vs 31% at the end of 2011. Two interesting facts, the Chinese government has increased its purchases of U.S. Treasuries this year at the fastest pace since such records have been kept (more than 30 years ago), and Russia refuses to sell its U.S. treasury holdings in any meaningful way despite threats to the contrary. These markets have to recycle and reinvest the U.S. dollar inflows and what better place than U.S. Treasury bonds. The U.S. remains the deepest and most liquid place to park cash globally, which leads us to the second lesson in bond investing which we witnessed during the depths of the global financial crisis: *Nobody cares about the yield when safety is at stake.*

Given the low yields, what should an investor do?

We at Lynx believe there is merit in being opportunistic and nimble with bond portfolios. Investing in total return strategies constrained by duration, geography or currency can add value to a portfolio in today's market. Another way to invest in bonds might be in the high yield bond market. Traditionally we have considered high yield bonds as surrogate equity when measuring portfolio risk, but given the tight spreads in the high yield market, we believe this asset class will be more highly correlated with traditional bonds until spreads widen. We therefore prefer low duration high yield because it has less interest rate risk, while typically maintaining a lower volatility profile. We would prefer active management in this space to monitor the underlying credits, but for investors interested in a lower cost alternative, we suggest SJNK, the Barclays Short Term High Yield Bond ETF. SJNK has an effective duration of 2.49 years, yields 4.94%, and has an expense ratio of 0.4% as of September 30, 2014.

Disclosure: Lynx Investment Advisory does not currently own or have any interest in shares of SJNK.