First Trust
Monday Morning OUTLOOK
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A Bear Market Is Here: In Bonds!

Brian S. Wesbury – *Chief Economist*
Robert Stein, CFA – Dep. Chief *Economist*
Strider Elass – *Economist*

While it certainly hasn't made the headlines that it should have, the bond market has been kicked in the teeth. After bottoming at 1.61% on May 1, the yield on the 10-year Treasury Note hit 2.84% on Friday, its highest level in two years – the worst bear market move in bonds since the end of the 2008-09 financial panic.

Someone who bought a newly-minted ("on the run") 10-year Note at almost any time in the past year has suffered a capital loss of about 10% - or approximately five years of interest payments. If investors hold these bonds to maturity, they would get back their investment and would continue to earn the coupon. But anyone who needs to sell now would face a serious loss, while the interest earned by holding would be well below current market rates. In other words, every investment, even the US Treasury Note, is risky.

The bear market in bonds should not be a surprise. We've argued for years that bonds were in a "bubble," with yields far below where they should be based on economic fundamentals. Over time, nominal GDP (real GDP growth plus inflation) has been a good proxy for interest rates. With this measure of total activity up 2.9% from a year ago, and up at a 3.7% annual rate in the past two years, rates should be moving higher. And, there is likely more to go.

Some believe this sell-off in bonds is due to talk of Fed "tapering" – slowing down and ending quantitative easing. With unemployment at 7.4%, and Chairman Bernanke apparently committed to end QE3 when it gets to 7%, there seems to be a correlation. We think the Fed will announce a tapering of QE3 at the September meeting, then, when it's clear the sky isn't about to fall, we think the Fed will announce another additional tapering in December.

But we don't think the rise in rates is due to "tapering"; after all the Fed is still buying $85 billion per month. What is really happening is that talk of tapering is moving the Fed closer and closer to the time when it will raise the federal funds rate. We believe that it's the zero funds rate, and the promise to keep it there for a very long time, that has held long-term rates down artificially. So, the more the bond market thinks the trajectory of short-term rates is higher than it thought before, the higher long-term rates will go.

This process has just begun. Typically, when the Fed has reached its most accommodative stance, the spread between the 10-year Treasury and the federal funds rates is 3.5%, or a little higher. It is currently around 2.7%.

At the very beginning of the year, when the 10-year yield stood at 1.78%, the consensus among economists was for the yield to rise to 2.35% by year end. Our target was a much higher 2.85%. A few economists had higher targets than we did, but they were mostly forecasting the Fed would raise short-term rates. By contrast, our forecast was for much higher long-term rates without a Fed move. Now, we believe long-term rates will end the year above 3%, maybe even as high as 3.5%.

Many view this rise in rates as a death blow to the economy, the housing market, and equities. We disagree. The US is still building fewer homes than it should, given population growth. And continued job and wage growth will make more renters think about buying.

Yes, the "housing affordability index" is down as mortgages rates and home prices are up. But the index is still much higher than it ever was before the financial crisis in 2008-09 and the index doesn't consider expectations of where home prices will go in the years ahead. A potential buyer today should be more interested at current mortgage rates, and today's outlook for home prices, then back in 2006, when home prices were still well above fair value.

And for years now, our equity models have incorporated a much higher bond yield (discount rate) than the market was suggesting. In other words, we have anticipated this move in rates and had it priced into our stock models. Equity prices are still up around 15% since the beginning of the year and we remain convinced that earnings, not low rates (or QE), are the driving force.

None of this means a bear market in bonds is easy to digest. It's not. But this process of normalization suggests the economy is also on more sustained footing. Rising rates suggest a better economy and a better economy suggests continued growth in earnings. Those who can see this, and remain invested in equities, should be richly rewarded.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-21 / 9:00 am	Existing Home Sales – Jul	5.150 Mil	**5.210 Mil**		5.080 Mil
8-22 / 7:30 am	Initial Claims Aug 17	330K	**328K**		320K
9:00 am	Leading Indicators – Jul	+0.5%	**+0.5%**		+0.0%
8-23 / 9:00 am	New Home Sales – Jul	0.487 Mil	**0.490 Mil**		0.497 Mil