What’s Right With This Picture? Nearly Everything!

**View from the Observation Deck**

1. The yield on the 10-Year T-Note spiked 103 basis points from 1.63% on 5/2/13 to 2.66% on 10/9/13. Bond prices, as a rule, tend to fall when interest rates rise. But there are exceptions.

2. When we say that nearly everything in this picture looks right, we are referring to the actual total returns posted by each debt category versus expected returns.

3. A common strategy used to counter rising interest rates is to shorten one’s duration. We know from open-end bond fund capital flows that many investors have been partaking in this strategy.

4. Year-to-date through August, open-end Bank Loan funds (senior loans) reported net inflows totaling $46.16 billion, according to Morningstar. That is very strong.

5. We expected floating-rate senior loans (leveraged loans) to outperform their fixed-rate counterparts as the yield on the 10-Year T-Note was bouncing off its historical lows. The duration of senior loans can be measured in days.

6. We also expected longer maturity bonds to decline in price more than shorter maturity issues, so it was not a surprise to see long-term municipal bonds down the most in this group.

7. What was a bit of a surprise was the severity of the decline in the EM (Emerging Market) Hard Currency Aggregate Index. Emerging market debt securities have tracked much closer to U.S. Corporate High Yield bonds in recent years.

8. Now that interest rates have somewhat normalized following the Federal Reserve’s statements concerning its desire to begin tapering its monthly bond-buying stimulus program, bond investors may have just gotten a break.

9. Yesterday’s nomination of Janet Yellen as the next Fed Chairman may prove to be a near-term positive for bond investors, if approved by Congress, in light of her comments supporting additional stimulus efforts.

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This chart is for illustrative purposes only and not indicative of any actual investment. The illustration excludes the effects of taxes and brokerage commissions or other expenses incurred when investing. Investors cannot invest directly in an index. The S&P/LSTA Leveraged Loan Index tracks the performance of a broad cross section of leveraged loans, including dollar-denominated loans to overseas issuers. The U.S. Treasury: Intermediate Index includes public obligations of the U.S. Treasury with maturities ranging from 1 to 9.9999 years. The GNMA 30-Year Index covers agency mortgage-backed pass-through securities (both fixed-rate and hybrid ARM) issued by Ginnie Mae (GNMA). The U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds. The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, USD-denominated, fixed-rate, taxable public utility bond market. The U.S. Aggregate Corporate Bond Index is a broad-based benchmark with maturities ranging from 1 to 9.9999 years that measures the investment grade, USD-denominated, fixed-rate, taxable corporate bond market. The U.S. Corporate High-Yield Index measures the market of USD-denominated, non-investment grade, fixed-rate, taxable corporate bonds. The Barclays Global Aggregate Bond Index is a flagship measure of global government debt from over twenty different local currency markets. The Barclays Emerging Markets Local Currency Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD, EUR, and GBP-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.