Fixed Income Insight
June 22, 2004

Bond Prices Retreat This Quarter: Higher Interest Rates Anticipated in Second Half of Year

No Sure Bet

Smarty Jones' disappointing loss of the Triple Crown last month reminds us that there is no "sure bet" in life. The Kentucky Derby and Preakness winner—a heavy favorite to gain the elite status of one of the best horses in decades—fell to a long-odds and relatively unknown contender in the closing seconds of the Belmont Stakes. In similar spirit, the financial markets are counting on the widespread consensus view that the economy is rolling at a pace that will likely trigger the Fed to hike interest rates through much of the rest of the year. In evidence of this popular sentiment, bond prices have moved downward since April 1st while yields have risen across most of the yield curve. Higher interest rates have been especially pronounced in the shorter end of the yield curve where a Fed hike would have the most direct impact. While, in our opinion, inflation concerns at the moment do not appear significant enough to warrant a sharp increase in rates, there are visible signs of emerging inflation that are prodding the bond market to maintain a defensive posture. Yet the sure bet of rising interest rates may be "upset" by other considerations.

Flattening the Yield Curve

Along those lines, given the growth in the economy, strong retail sales, rising fuel prices and more jobs, it follows conventional logic that bonds should underperform relative to other asset classes in the near term and for the second half of the year. However, the difficult question is whether the Fed will increase rates in significant and frequent increments as they did in 1994, or whether the Fed's response will be slow and measured. Still, there are challenges that could emerge and upset what seems to be the market's "sure bet" of a nearly 150 basis point increase in the Fed Funds rate by the end of the first quarter of 2005. First, the threat of terrorism and a potential flight to quality loom in the backdrop of what otherwise looks like a growing global economy. Second, while high fuel costs could help lead inflation upward in the short term, higher energy prices could eventually cut corporate profits, reduce disposable spending and dampen growth if supply shortages are not overcome. These countervailing factors have been working to tame the market from moving to higher yields too quickly, especially for longer term bonds. In essence, the combination of bearish near term indicators and potential bullish long term factors are working to flatten the bond yield curve.

Back to the Future

Comparisons to 1994 are frequently heard these days. A decade ago, the market experienced a steep climb in interest rates in line with the actions of an aggressive Fed bent on holding down inflation. During that episode in economic history, interest rates rose nearly 300 basis points from the 10-year Treasury note low on October 14, 1993 at 5.17% to a peak of 8.03% by November 7, 1994. The Fed probably got ahead of itself that year as the bond market readjusted in 1995 to close with interest rates on the 10-year note back down to 5.57%.

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Guiding Portfolio Strategies

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The possibility of history repeating itself in a similar fashion is not out of the question if the Fed overplays the risk of inflation. However, the market is never exactly the same as it once was. The current market has been anticipating the Fed's tightening far more this time than in 1994 and 1995 when the Fed abruptly stepped in and raised rates seven times for a cumulative increase in its lending rate of 3.0%.

Over the past year the market has prepared for the Fed's action by requiring higher interest rates, particularly on intermediate maturities. For example, in the one-year period from June 13, 2003 to June 14, 2004, the yield on the 5- and 10-year Treasury notes rose by 206 and 175 basis points, respectively. We believe that short 1-year maturities may have more vulnerability to larger percentage increases in their current base rates. Monetary policy has been particularly loose for the past few years given the fact that the Fed Funds rate, when measured in real interest rate terms, is actually negative. This, coupled with recent evidence of creeping wholesale and consumer price inflation, strongly suggests that some Fed tightening is in order in the near term.

Inflation does not usually peak until a year or two after the Fed recognizes that the economy is picking up steam and begins the tightening cycle. If the Fed delays the apparently necessary short term Fed Funds increase, this could lead to an even higher inflation rate that would necessitate aggressive action—more like what we saw in 1994. Finally, the risks mentioned before regarding terrorism and the impact of rising oil prices could act to suppress soaring interest rates and lead to a recovery in bond prices as geo-political and economic events unfold.

Bond Returns Year to Date

Bond total returns are generally in negative territory year-to-date albeit the losses are relatively modest. The table below summarizes the total return performances of the following Lehman bond composite indices through June 16, 2004*:

Index	Return
▪ US Treasury	-0.98%
Intermediate	-0.80%
Long Treasury	-1.56%
▪ Investment Grade Corporate	-1.01%
▪ Mortgage-Backed Securities Fixed Grade	+0.08%
▪ Corporate High Yield	+0.61%
▪ Municipal Bond	-1.35%

** Source: Lehman Brothers*

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The mortgage-backed corporate indices fared somewhat better than corporates—mostly due to the lower duration of the associated securities as well as the fact that rising interest rates helped reduce prepayment risk. Another area of the taxable bond market that squeaked into the positive column is the composite index for U.S. Corporate High Yield with a scant, but in the black, return of +0.61%. Municipals have underperformed Treasuries for the year. The hardest hit maturities have been on the long end of the market and in the 7- to 10-year maturity range. Hospital tax-exempt bonds fared among the best credit sectors (-0.03%) while Industrial Revenue Bonds had the worst return (-2.93%).

Reflecting Back on Our Outlook for 2004

As we reflect on our January 15, 2004 Fixed Income Outlook for 2004, we said:

> *"Barring catastrophic surprises, current economic momentum along with fiscal and monetary policies make it hard to argue that the economy is likely to weaken over the next twelve months. Inflation is likely to move higher given expected 4-5% GDP growth as well as commodity prices and foreign currency trends. In addition, the White House is likely to do all that it can to help create jobs in this election year. At the same time, the Fed continues to justify a low federal funds rate based on slow job growth, strong productivity and restrained inflation, as well as the potential for sudden global disruptions. We worry that waiting too long to proactively blunt inflation, a sudden inflationary surge could occur in 2005 (or as late as 2006), with serious ramifications for leveraged industrial and individual borrowers.*
>
> *… By late in the second quarter of 2004, we expect the Fed to begin changing its cautionary tone related to the relative weakness of the economy. Improved corporate earnings and activity are likely to necessitate some additional hiring and increasing technology purchases, and capital investment should enhance job growth for select manufacturers as well as many service industries. In the interim, the stock market should hold its positive momentum while the bond market adjusts to higher rates, particularly in the short to intermediate (i.e. 2-year to 5-year) maturity range, producing some yield curve flattening. This view is especially vulnerable to event risk having to do with global politics and terrorism. To some extent these risks will keep bond prices within a range since bonds—especially Treasuries—are still the preferred defensive refuge in uncertain times."*

That's exactly what has been happening this year, which is why we continue to hold our 2004 Outlook in place without change.

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In Conclusion

By year end, we expect that the Federal Funds rate could be in the range of 1.5% to 2.25% based on the current trend of conditions, barring global geo-political and other highly irregular events. While Fed Funds are poised to move higher in the short term, the longer term trend for rising interest rates is not a "sure bet." As we know, upsets can happen.

Key Rates on 6/17/04*:

	Treasury Yields	***Corporate Yields (AA Industrial)***	***Municipal Yields (AAA MMD Uninsured)***
2-year	*2.76%*	*3.17%*	*2.14%*
5-year	*3.91%*	*4.33%*	*3.17%*
10-year	*4.68%*	*5.24%*	*4.02%*
30-year	*5.35%*	*6.00%*	*5.04%*

** Source: Lehman Brothers*

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