

Why the Bond Market Cried Uncle

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Over the two weeks ending November 18, the yield of the 10-Year Treasury soared 57.9 basis points (bps). Over the last 30 years, only two such periods saw larger increases—April 10, 1987, and November 23, 2001—making the third largest rise in the 10-Year Treasury yield. More inclusively, in a 30-year bull market in bonds, it is the eighth largest two-week move, regardless of direction.

[\[Image unavailable\]](#)

Bond Market Risk

Given the comparable periods, the 2016 election seems a little out of place. But a deeper look at the state of the bond market from a risk/return perspective might suggest that there is more substance in the move. The election surprise and its promise of fiscal policy simply offered the trigger that exposed those vulnerabilities.

The extraordinary level of monetary accommodation and the lower-for-longer rate environment has encouraged issuers to issue more bonds and in longer maturities. The large majority of bond investors are captured investors—they need to invest at least a portion of their assets in fixed income. While the decline in yields has pushed some marginal investors into equities, a large majority of bond investors have continued investing as yields declined, not just in the United States but globally.

That dynamic pushed real yields to negative levels, and investors tolerated assuming an increasing amount of interest rate risk as durations soared. As a result, the bond market's overall sensitivity to interest rate risk soared to record levels, while the anticipated compensation continued to fall. The graphs below show the dynamics at play.

[\[Image unavailable\]](#)

Market Value at Risk from 100 bp Shock

[\[Image unavailable\]](#)

“Running to Stand Still” Becomes “Gimme Shelter”

That was fine as long as global risks remained front and center, the U.S. government remained gridlocked and a pervasive threat of deflation lingered. We were all, in the words of the great Irish poets U2, content with “Running to Stand Still.”

Then, the shock of Brexit dissipated in a flash and prices in China ticked higher. Deflation fears ebbed. With yields depressed and the assumption of interest rate risk high, investors became more sanguine about bonds. They also became more cognizant that they were sacrificing yield in assuming duration

risk (a negative term premium), and bond yields began to move higher. With the election surprise, the repricing simply got pulled forward in spectacular fashion. The Rolling Stones' "Gimme Shelter" might offer an appropriate musical backdrop.

Did we get ahead of ourselves? Quite possibly, the Treasury market reached technical oversold levels it had not seen since 1990. Investors also need to remember that the prospect of fiscal policy is quite different than its actual implementation. A key takeaway from the election is to expect the unexpected. Investors should hope for It's a Small World, but be prepared for Space Mountain, not spinning tea cups. Risks remain prevalent, and investors should probably use any recovery in the bond market as an opportunity to dial down their interest rate risks.

We believe anticipated fiscal reform, regulatory relief and tax cuts to be pro-growth in nature and to offer support for valuations in the credit market. Zero duration and negative duration strategies that combine credit exposure with more advantageous positioning for interest rates could thus serve as a useful complement to core fixed income strategies in the months ahead, in our view.

We encourage investors to think strategically in positioning portfolios toward year-end.

Important Risks Related to this Article

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. In addition, when interest rates fall, income may decline. Fixed income investments are also subject to credit risk, the risk that the issuer of a bond will fail to pay interest and principal in a timely manner or that negative perceptions of the issuer's ability to make such payments will cause the price of that bond to decline.