On The Bubble

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With interest rates at historic lows, prices on all manner of income-producing securities have been bid up considerably over the past several years. With the memory of the real estate bubble still very fresh in investors' minds, it's natural to wonder whether we are in the middle of another bubble, in this case a fixed income bubble that could burst if rates suddenly rise from their currently depressed levels.

Although bond yields are historically low and valuations have indeed run up in the past couple of years, that's really as far as the bubble parallels extend, in our view. While an abrupt movement in rates may result in a short-term correction in bond prices, the inherent nature of bonds makes it extremely unlikely that investors would suffer the sort of permanent capital destruction that asset bubbles typically cause.

NO BIG SURPRISES

Asset bubble scenarios generally stick to a clear pattern. Investors come to expect outsized profits from a given asset class, whether it be Internet stocks, real estate or Dutch tulip bulbs, and they subsequently stampede into that asset class. Then, at some point, the "irrational exuberance" of the market evaporates due to one or more trigger events, and investors flee en masse, causing a collapse in valuation from which the asset class may take years to recover, if ever.

Current circumstances in the bond market are far from irrationally exuberant. Observers are in near-universal agreement that rates will inevitably rise and that there is little room for further improvement in bond valuations. Indeed, in the November 2012 Bloomberg survey of economists, only two out of 65 economists expect the 10-year Treasury rate to fall in 2013 (and those two expect the rate to drop a mere 0.10%). If and when the bond market turns, it will be the most widely anticipated bear market of all time. So the bond market does not appear to be following the emotional pattern of a bubble scenario.

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Another common element of asset bubbles is the severity of capital losses and the extended periods of time it takes to recover from those losses. For comparison purposes, during the 2000-2001 collapse of the Internet bubble, the NASDAQ Composite lost 77.9% from peak to trough. For 10-year Treasuries to lose that much over the course of one year, their yield would have to rise from their November 30 level of 1.62%, to *22.90%.* For a more recent comparison, the S&P 500 Index declined by 57% from October 2007 to March 2009 as a result of the collapse of the housing bubble. For 10-year Treasuries to replicate those losses over the course of a year, their yield would need to rise to 12.86%. Clearly, such rate spikes are unlikely.

So what would a realistic outcome look like? We can provide some perspective by looking at how a basic fixed income portfolio might be managed over a period of several years, and how that portfolio would react in a rising-rate environment.

We'll examine an investment-grade corporate bond portfolio, allocated equally between 1-, 2-, 5-, 7- and 10-year maturities, and rebalanced annually to fresh bonds matching those initial maturities. A realistic bearish scenario for bonds might see 10-year Treasury yields rising to 5.00%, from their current level of 1.62%. For simplicity's sake, let's assume that such an increase occurs immediately after establishing the initial portfolio, and that Treasury yields for other maturities rise by a similar amount. (Note that the largest 1-year increase in modern history for 10-year Treasury yields was +2.10% in 1980, so our assumed increase of +3.38% would be extremely unusual.)

Under this scenario, performance is moderately negative in the short-term but recovers quickly. The hypothetical portfolio would decline by 8.48% in Year 1, thereafter turning positive (buoyed by reinvestment in bonds with higher yields) and breaking even at some point during Year 3. While not an ideal investment outcome, this result is a far cry from the sort of scenarios that investors fear from asset bubbles. The NASDAQ Composite is still more than 40% below its March 2000 high 12 years later; the Japanese Nikkei Index is over 75% below its 1989 peak *23 years* later.

BUILT-IN CUSHION

This result is not unique to any particular set of current economic circumstances; the nature of bonds generally prevents severe bubble-collapse events. When yields rise, a bond's principal value will decline, but its forward-looking return potential is higher. For example, if the 10-year Treasury rate rises to 5.00%, Treasury holders will experience a loss in the moment but will earn a 5% yield thereafter. Just as importantly, fixed-income portfolios always have maturing bonds, and higher rates means the opportunity to reinvest at those rates. These factors act as a natural downside cushion against severe losses.

Thus we would argue that the term "bubble" connotes a much more dire outcome than what we believe is reasonably possible for a typical bond portfolio. That being said, a significant single-year loss in bonds would still be unwelcome to investors, so some consideration of what might boost interest rates is in order.

Interest rates are the means by which the economy balances savings (in simple terms, cash deposited at lending institutions) with investment (in simple terms, hard assets such as office buildings, factory equipment, houses, and other durable assets paid for with borrowed funds). The reason why interest rates are so low currently is that the demand for investment is weak, while the supply of savings (particularly from China and other countries with high saving rates) is plentiful.

For interest rates to move significantly, either investment demand needs to rise or savings needs to fall, neither of which is likely to occur until economic growth improves. Investment demand will improve when businesses see more opportunities to expand their operations. When that happens, banks will undoubtedly increase lending activity, unleashing their vast capital reserves into the economy. While interest rates would rise in this scenario, potentially hurting fixed income investments, the good news is that stocks and other risk assets would likely respond positively to an environment of renewed optimism and opportunity for earnings growth.

The high global savings rate is a bit more entrenched, and in some cases culturally ingrained. But if savings were to decline meaningfully, then economic growth would benefit. For example, if China as a nation saved less, by definition its citizens would be consuming more. This would be a boon to various global companies, which would either sell more product directly in China or sell component parts into China. It would also cause the Chinese yuan to appreciate, making it easier for non-Chinese manufacturers to compete in the global marketplace. As with the investment demand story, this scenario would likely have a negative impact on bonds but a positive impact on stocks and other risk assets.

The common thread in both of these scenarios is that when bonds do poorly, stocks are likely to do well. The inverse is also true: If the economy were to fall back into recession, stocks would likely retreat but bonds would hold up relatively well. So even though low interest rates limit the upside potential of bonds, we believe that they are still a crucial component of any well-diversified portfolio, in order to best prepare for the full range of possible economic outcomes.

The S&P 500 Index represents the large-cap segment of the U.S. equity markets and consists of approximately 500 leading companies in leading industries of the U.S. economy. The NASDAQ Composite Index is a market capitalization–weighted index that is designed to represent the performance of NASDAQ stocks. The Nikkei Index is an unmanaged price-weighted index of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange. One cannot invest directly in an index.

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