

## 2014 Mid-Year Review and Outlook

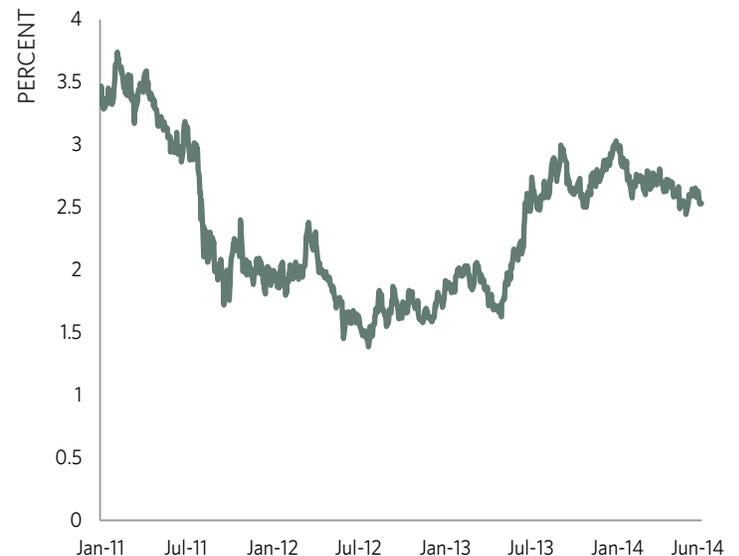
### Bonds Defy Expectations with Strong Performance

One of the most surprising aspects of the capital markets during the first half of 2014 was the bond market's strong performance. Most industry experts had believed that stronger economic activity coupled with the continuation of the Federal Reserve's (Fed) tapering program would move interest rates higher, with negative implications for bonds. However, significantly weaker-than-anticipated economic activity in the U.S. and persistently low global sovereign interest rates helped buoy Treasury bond prices and the broader bond market. First quarter gross domestic product (GDP) was dramatically below expectations, showing a contraction of nearly 3%. While most economists note that the decline was primarily due to severe weather conditions throughout much of the U.S., the degree of weakness gave bond market participants enough rationalization to push yields lower.

### Treasury Bonds

Even as the Fed reduced its bond-purchase program by \$10 billion at each of the Federal Open Market Committee meetings in 2014, the demand for Treasuries was strong given their relatively high yields versus other global sovereign bonds. The yield for the benchmark 10-year Treasury note closed the second quarter at 2.53%, after starting the year near 3%. The decline in Treasury yields was much more pronounced in longer dated securities. The 30-year Treasury bond fell more than 60 basis points (bps) compared to the two-year Treasury note, which increased by almost 10 bps. As a result, long-term bonds outperformed their short-term counterparts. During the first half of the year, the 30-year Treasury bond returned an impressive 14% while the five-year Treasury note returned 2%. Treasury Inflationary Protected Securities (TIPS) had a relatively quiet period compared to last year's disappointing performance. While the implied inflation breakeven rate on 10-year TIPS was essentially unchanged at 225 bps, the breakeven rate

### 10-Year Treasury Yields



As of 6/30/14. Source: Bloomberg

on five-year TIPS improved from 183 bps to 207 bps. The increase in the breakeven rate helped the overall sector outperform nominal coupon Treasuries by a material amount. Intermediate-dated TIPS had a total return of 4% versus 1.57% for comparable nominal Treasuries.

### Corporate Bonds

Corporate bonds delivered solid returns for the period, primarily supported by strong investor demand, solid corporate fundamentals and an improving economy. Investment grade corporate spreads tightened 14 bps, to end the period slightly below 100 bps—the narrowest spread differential between corporate bonds and comparable Treasuries since 2007. The media sector had the most significant tightening of all the subsectors. Time Warner Cable was the main catalyst for the subsector's outperformance following the news that the corporation was being acquired by Comcast.

Supply of investment grade corporate bonds is on track to surpass last year's record-setting level of \$1.14 trillion, with total supply equaling \$668 billion for the first half of 2014. Apple Inc. had the largest single deal totaling \$12 billion, which was issued primarily to avoid repatriation of foreign domiciled revenues. It was less expensive for Apple Inc. to borrow rather than to pay U.S. corporate taxes on foreign revenues.

Once again, high yield corporate bonds outperformed Treasury securities. The Barclays High Yield Index generated a total return of 5.46%, compared to 3.93% for the Barclays Aggregate Index. In fact, on a semi-annual basis, high yield bonds have outperformed Treasuries every quarter since 2008, with the exception of late 2011. Credit spreads were tighter given investors' appetite for yield and low actual default rates. During the period, high yield credit spreads tightened 45 bps to end the period at only 337 bps above comparable Treasuries. The 10-year average of high yield credit spread is close to 560 bps and the all-time tight is roughly 230 bps, which occurred in 2007. Weaker corporations continue to opportunistically issue debt to take advantage of historically low rates. In fact, high yield issuance totaled \$195 billion, which is also on pace to exceed last year's record-setting level of \$379 billion.

## Municipal Bonds

Dramatically lower-than-expected supply was the main story for municipal bonds during the first half of 2014. Total new issue supply in the first half of 2014 was \$109 billion, nearly 30% less than the total new issuance in 2013. Refinancing activity declined more than 50% compared to last year's levels. From a demand perspective, the environment has dramatically improved compared to last summer. Year-to-date, open-end municipal bond funds have recouped nearly \$6 billion of the nearly \$60 billion redeemed in 2013.

Similar to the Treasury market, long-dated municipal bond yields fell more than short-term bonds. While all maturity profiles posted positive returns, long-dated maturities outperformed short-dated maturities. For example, the long bond (22 years+) posted total returns of 10% versus the

## U.S. Corporate Investment Grade Spread



## Fixed Income Sector Returns



As of 6/30/14. Source: Barclays Capital

five-year, which delivered roughly 2%. Lower credit quality outperformed higher credit quality, with BBB-rated securities outperforming AAA-rated securities by more than 5%. Hospitals surpassed all municipal sectors and posted a total return just below 8%, meanwhile pre-refunded bonds suffered due to their higher credit quality bias and short maturity profile.

## Municipal Credit

As we have highlighted in the past, the overall landscape of municipal credit has been improving. Slow but improving economic activity coupled with an appreciating real estate market has resulted in increased revenue flow for both states and localities. Some states and localities have seen notably better budgetary profiles shifting from deficits to surpluses. An obvious example is the state of California, which went from an approximate \$15 billion deficit to a \$3 billion surplus in three years. Not surprisingly, the rating agencies are still somewhat cautious and the ratio of upgrades to downgrades has shifted to a more neutral profile. Pension and post-retirement healthcare obligations are still an issue that states and localities need to address. Most issuers have done an admirable job of recognizing the challenge and are trying to slow the upward trajectory of their liabilities. We still believe that the pension issue will not immediately result in a material acceleration in bankruptcy filings. If certain states and localities do not address these issues in timely manner, there may be material defaults within 10 to 20 years.

The city of Detroit filed bankruptcy last summer and now, a year later, is very close to resolution. Most of its creditors have agreed to some form of restructuring. Now it appears that certain issuers within the Commonwealth of Puerto Rico may be following Detroit's lead. In late June, the government of Puerto Rico enacted new legislation called the Puerto Rico Corporations Debt Enforcement and Recovery act. This act provides a blueprint whereby specific issuers can restructure their debts similar to the parameters of Chapter 9 available within the 50 continental states. The authorities impacted are Puerto Rico electric power, Puerto Rico aqueduct and sewer and Puerto Rico highway. All other issuers, including Commonwealth general obligation bonds and sales tax-backed bonds, are excluded from the act. The office of Governor Padilla has downplayed debt restructuring under the law, except in extreme cases. This act has brought into question the Commonwealth's willingness to pay their debts, which has previously been articulated as a high priority. The rating agencies and market participants have reacted less optimistically about the likelihood of Puerto Rico utilizing the new restructuring powers.

## Municipal Credit Quality Returns



As of 6/30/14. Source: Barclays Capital

## Outlook

We expect the domestic economy to reaccelerate after a disappointing first half of 2014 to a pace of about 3% over the next several quarters. Given that backdrop, the Fed will continue on its path of tapering open market purchases of longer dated Treasury and mortgage-backed securities and will completely end its purchasing program before the end of 2014. This also sets up the potential for the Fed to finally move away from its zero interest rate monetary policy by mid-2015.

Interest rates on intermediate- and long-dated Treasury securities should trend higher over the next several quarters, but we are not anticipating a big jump up in rates. Global demand from sovereign and pension-orientated fixed income buyers should continue to act as a buffer for materially higher interest rates. Inflation appears to be heading slightly higher, but still not consistently above the Fed's target of 2%. Inflation would have to move toward 3% for the bond market to be concerned enough to warrant significantly higher interest rates in the quarters ahead. As a result, our range for the yield on Treasury 10-year benchmark note is between 2.375% and 3.25% for the remainder of the year.

We expect corporate bonds to continue to outperform Treasuries even though the additional yield spread is narrow. Corporate balance sheets are extremely strong with a significant amount of cash. In addition, with expectations for improved profitability we expect defaults to remain low. The low spreads within high yield are more worrisome because there is less opportunity for appreciation moving forward, although the sector will benefit from an improving economy.

While municipal bonds should continue to benefit from their low supply environment, credit concerns with issuers like Puerto Rico increase the probability that demand may wane. It is possible that Puerto Rico may seek to fully restructure some of its authority debt before year end. If this occurs, demand could temporarily decline. We do not believe the municipal market will repeat the mass exodus experienced last summer, but we are also not optimistic about a huge increase in

demand. Consequently, the degree of outperformance of municipal bonds experienced year-to-date is unlikely to be replicated during the second half of the year.

Despite predictions to the contrary, the first half of 2014 produced solid returns for the entire fixed income marketplace. We expect more modest returns during the second half of the year given our expectation for rates to gradually move higher. While we continue to advocate a core portfolio of high-quality, intermediate-term bonds complemented by modest exposure to higher yielding securities, investors should ensure they are not overexposed to any high risk sector within the bond market. Bonds should continue to fulfill their role of principal protection and diversification; however, we believe that thoughtful risk control and bottom-up security selection is particularly critical in this environment.

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### About the Author

**John F. Flahive**

**Director, Fixed Income Investments**

John is the director of fixed income for BNY Mellon Wealth Management and is responsible for all fixed income strategy, policy and management. He is chairman of the Bond Strategy Committee, and is a member of the Investment Strategy Committee, Investment Policy Committee, and Asset Review Committee.

He has more than 20 years of investment experience and has been an investment manager with the firm since 1994. Prior to joining the firm, he was a senior portfolio manager and vice president with Neuberger & Berman, and a vice president and associate portfolio manager with T. Rowe Price.

John holds a bachelor's degree in business administration from Saint Michael's College and a master of business administration from Clarkson University, and attended New York University's Graduate School of Business Administration for Visiting Professionals. He is a CFA charterholder.