



BOND MARKET COMMENTARY

“I... place economy among the first and most important virtues, and public debt as the greatest of the dangers to be feared.” Thomas Jefferson, 1816

As we move from summer to autumn, we find the US economy at crossroads with Keynesians (disguised as politicians) pushing for a new round of quantitative easing (now dubbed QE2) while others (mainly scholars and economists) believe we should let the passage of time heal the economy's woes. While this debate should rage on through the upcoming election, the end result will be one of the biggest factors in determining the fate of the bond market... The more stimulus that is injected, the longer rates stay low.

We enter this period with interest rates at an all-time low, while the spread between the short end and the long end is at an extremely wide level (known as a “steep” yield curve).

Historically, the yield on 30-year Treasury bonds is one to two percentage points above the yield on three-month Treasury bills. When it gets wider than that — and the slope of the yield curve increases sharply — long-term bondholders are sending a message that they think the economy will improve in the near future. Conversely, when the spread is less than one percent (a flat yield curve), the prospects for the economy become negative. Ultimately, a negative spread (an inverted yield curve) points to doom and gloom for the economy. Although the recent events are atypical, the steepening is quite apparent (3 month Treasury notes 0.14%, 2 year Treasury Notes – 0.35%, 30 year Treasury Bonds – 3.92%⁽¹⁾).

Many economists and portfolio managers, alike, feel that the front end of the curve is being kept artificially low by the current loose monetary policy of the US Federal Reserve, as it is well documented that Ben Bernanke is using all measures to help stimulate the sluggish economy. The thought process behind this policy indicates that the Fed believes lower interest rates will provide US consumers with more spending power when it comes to buying goods and repaying debt.

Households and corporations alike have used this opportunity to refinance loans at these low rates. The current 30 year mortgage rate stands at 4.24%⁽²⁾ which has caused unprecedented refinancing over the past 18 months. The result of the refinancing was supposed to give consumers more money in their wallets to spend. Unfortunately, this has not occurred as the events of the past 3 years have many people spooked and, consequently, looking for places to put the money into savings.

The problem is that the low borrowing rate also means that banks are paying historically low interest rates (the average national bank savings account rates is 0.78%⁽²⁾). This phenomenon has caused savers to look elsewhere. With the stock market still posing too much risk for many, a record amount of assets have flown into US Treasury Bonds which normally pay a higher return than CDs and bank accounts.

This in turn has created a natural supply and demand issue, causing prices to rise and yields to shrink across the yield curve. As these rates declined, many investors have decided to increase their risk tolerance and buy corporate bonds which normally pay a much higher rate than the Treasury bonds. Amazingly, despite a sluggish economy, this has also caused a supply/demand conundrum that has forced prices higher and yields lower. This has also created the ability for corporations to issue new bonds (i.e. borrow) at these artificially low rates. Many corporations have used this opportunity to refinance debt while many cash rich companies (such as PepsiCo and IBM) have used this time to lock in low rates despite the fact they do not need the cash.

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In a perfect world, these lower rates would then give both the consumer and the corporations the cash needed to increase spending, yet economists complain that apart from a few notable corporate acquisitions that were financed largely with pent-up cash, many businesses are sitting on their money rather than spending it, while individuals remain flummoxed and, hence, sitting on the sidelines waiting for advice. Ultimately, this has undermined the purpose of low interest rates, which is to get companies and consumers spending again.

As a result, many pundits are calling for a bond market bubble, with some forecasting that the result of the stimulus will be inflation which will in turn send interest rates higher.

If this happens, it is important that investors know the inherent risks of certain bonds. Chart 1 demonstrates how a rise in interest rates would affect the value of a bond over 12 months. Chart 2 demonstrates how a decline in interest rates would affect the value of a bond over 12 months.

Chart 1

	Current Yield	Current Price	Yield up 1%	12 Month Total Return	Yield up 2%	12 Month Total Return
2 year bond	0.35%	100.05	99.09	-0.58%	98.17	-1.51%
5 year bond	1.08%	100.82	96.87	-2.69%	93.25	-6.36%
10 year bond	2.46%	101.43	93.7	-5.08%	86.74	-12.17%
30 year bond	3.88%	99.91	84.53	-11.77%	72.31	-25.16%

10/20/2009 Data From Bloomberg LP. Logan Capital is not responsible for accuracy of this data.

Chart 2

	Current Yield	Current Price	Yield down 1%	12 Month Total Return	Yield down 2%	12 Month Total Return
2 year bond	0.35%	100.05	100.5	0.82%	100.97	1.29%
5 year bond	1.08%	100.82	102.607	2.99%	104.6	4.93%
10 year bond	2.46%	101.43	105.36	6.33%	109.61	10.33%
30 year bond	3.88%	99.91	109.07	12.56%	119.39	22.00%

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	Current Yield	10 Year Average Yield	Total Return if Normalized in 18 Months
2 year bond	0.35%	2.80%	-0.36%
5 year bond	1.08%	3.54%	-4.25%
10 year bond	2.46%	4.20%	-5.69%
30 year bond	3.88%	4.77%	-5.39%

10/20/2009 Data From Bloomberg LP. Logan Capital is not responsible for accuracy of this data.

At Logan Capital, we feel that the shorter end of the curve will remain anchored as the Federal Reserve will keep the target interest rate near zero and use non-traditional means of keeping short term financing cheap and easily accessible--the desired result of which is to jumpstart spending which will ultimately reduce the unemployment rate.

We also expect this policy to force savers to decrease their allocations to bonds as they look elsewhere for income and capital gains. In addition, we fear that as central banks raise their respective borrowing rates (Canada and Australia have already done so), pressure will be placed on the US to do the same in order to remain an attractive option.

Lastly, it must be noted that the US has record deficits that must remain funded and, hence, depend on a global demand for US Treasuries. Foreign ownership of US Federal debt is currently 30% of total debt outstanding.⁽³⁾ This represents a 61% jump since 2000 (19% of outstanding). If this demand slows, interest rates could rise faster than expected in order to entice these countries to buy US debt. If any of these scenarios occur, we expect rates to drift higher and warn that the reversion to normalized levels will produce negative bond market returns over this period. While it is important to point out that rates do not usually move in a parallel fashion, we do feel that at this point, there is a greater danger of the longer end of the curve returning to a more normalized level at some point in the next 18 months. Timing this move in rates will be very difficult as the psychological factors will most likely trump the statistical factors. We expect more and more chatter in the press forecasting a bond market bubble which should act as an eventual self fulfilling prophecy and send rates higher. In this case, Chart 3 demonstrates how this reversion will impact specific bonds.

As a result, we advocate decreasing duration within portfolios and accepting lower current yields to protect your portfolios from potential principal loss.

Jonathan Heckscher, October, 2010

The Logan Fixed Income Process

First, Logan Capital Investment Committee sets a duration target based on a macro view of the economy. The duration target is based on forecasts of probable trends in interest rates and is performed on a continual basis. These forecasts are supported by detailed analysis of important economic factors and lead to adjustments in the average maturity of our bond portfolios. At the same time, the changing shape of the yield curve is evaluated to determine the spacing of our maturities.

Next, our managers look at the market for a value- based decision on sectors--essentially buying bonds in sectors that offer value versus the US Treasury and selling bonds in sectors that no longer offer a perceived value. Our managers look at the market in terms of individual sectors, such as governments, municipals, corporates, asset-backed securities, and mortgage securities. Relative valuation between sectors is an important consideration. We invest in those sectors that offer superior absolute and relative value with consideration given to the sector's performance outlook and its historical normal spread to Treasuries. Sectors which Logan believes are undervalued will generally be over weighted in the portfolio and subsequently sold as they become fully valued.

Next, our managers utilize scenario analysis to model each portfolio. Volatility management allows us to assess both portfolio and individual security risk, given current and potential market movement. Volatility is a comprehensive measure of portfolio risk that captures sector, security, duration, yield curve and other non-traditional sources of risk. This analysis is accomplished through the use of interest rate simulation, sector and security sensitivity analysis, and portfolio modeling which allow us to analyze the effect of interest rate changes on our portfolio.

Lastly, we select the individual securities that will make up the portfolio. Individual security selection is bottom-up and based upon analysis of each individual investment. As value investors, we seek to identify securities that are inefficiently priced and/or misunderstood. Our focus is on the spread between a specific security and a comparable duration Treasury or peer group issues. Our internal research team is responsible for specific security recommendations.

Please contact Jonathan at jmheckscher@logancapital.com or 215-851-9317 with questions or comments.

Sources:

- (1) Bankrate.com (September 22, 2010)
- (2) Bloomberg, L.P. (September 21, 2010)
- (3) Financial Management Service , Treasury Bulletin, September 2010 edition <http://www.fms.treas.gov/bulletin/index.html>