The Good, The Bad and The Sort Of

Bond market rallies produce a mixed bag of investment results

By Jim Reber

Here, early in 2015, it may be worthwhile to revisit a drop in interest rates last year that 1.) was widely unforeseen, 2.) was breathtaking in its strength, 3.) happened more than once, and 4.) repeated itself in almost an eerie pattern.

Any self-respecting risk-averse analyst, such as your columnist here, should now disclose that past performance is not indicative of future returns. But that isn’t really the subject of this piece. What the two mini-rallies of 2014 provided to us, other than a temporary improvement in the market values of our holdings, is a good case study in what happens to bonds owned by community banks when interest rates suddenly and unexpectedly drop.

And in this bicentennial year of the Battle of Waterloo, there are some lessons to be gathered. One is that the bond market can actually behave rationally, even in a volatile market. And, given this, a wizened portfolio manager can prepare himself or herself for the next running of the bond bulls.

History repeated
Bond analysts like to pay attention to the benchmark Treasury notes to quantify price and yield movements. A convenient starting point is the five-year Treasury, since that is a rough equivalent of the average maturity in many community bank investment portfolios.

Almost anyone willing to publish a guess as to where rates would be moving in 2014 said that yields were heading higher; the five-year note was as high as 1.76 percent on Jan. 8. By Feb. 3, the yield had dropped fully 33 basis points to 1.43 percent, as a series of weak reports on the economy hurt the stock market, and buoyed bonds.

Fast-forward to the fall, and rates had again crept higher, with the five-year note peaking at 1.83 percent.
on Sept. 18. Again, a series of events, some of them geopolitical, ignited the bond market, and when the smoke cleared on Oct. 15, the rate was down to 1.34 percent. This was virtually a copycat of the January rally.

**Burgeoning spreads**
The subplot within both data series was what happened to the price of investments actually owned by community banks. In both instances, the prices rose far less than those on the five-year note, which is another way to say that spreads widened. This is a common occurrence, but many portfolio managers haven’t drilled down to the “why.”

In theory, yields drop because investors have expectations of falling inflation. Usually, the reason inflation decreases (“disinflation”) is that general economic health declines, and demand for goods and services does also. This puts a crimp in the financial wherewithal of borrowers. Investors in their debt, which also makes them creditors, demand incremental compensation for the increased credit risk, real or perceived.

The second part of the answer is that for securities that can be called away early (which is the majority of what a typical community bank owns), lower yields equal premium prices. For a callable bond, the yield to the earliest call date gets hammered when the price begins to rise above par. As a consequence, prices for callable bonds don’t rise completely in step with non-callables (like Treasuries), and this too causes spreads to widen.

For example, let’s take our example five-year Treasury note from last February. As the Treasury’s yield fell 33 basis points in a four-week period, the yield on a five-year callable bond issued by Fannie Mae or Freddie Mac fell only about 23 basis points. We can therefore conclude that yield spreads widened 10 basis points.

**Built to endure**
What this brings into stark relief is one of the dilemmas of managing a bond portfolio. If your community bank owns bonds that are immune to the spread-widening phenomenon, it is limiting its downside as rates fall. Examples are pretty few: Bullet agencies come to mind. Since they can’t be called, and since their credit quality is right up there with Treasuries, they shouldn’t see their incremental yields fluctuate much.

However, that also won’t position your community bank to purchase items whose yields are unusually, temporarily high after a bond market rally. MBGs of many varieties, and high-quality corporate and municipal bonds, often see their spreads widen when Treasuries go on a tear.

So where we end up is the recommendation to, you guessed it, diversify! Being flexible in your bank’s investment choices, and real-locating its bond weightings between sectors as they become more or less expensive on a relative basis, are both a part of proactive and sound portfolio management. Sort of.