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Fighting for income

Interest rates have been on a long and slow decline for the last 30 years. Unfortunately, there must be a bottom. The sharp spike in rates since the beginning of May signals an end of an era. During the past 30 years, fixed income assets provided exceptional returns, especially on a risk adjusted basis. This is the income many people relied on to live and retire. Now, with interest rates reversing from a multi-decade decline, investors must search for new ways to find income.

The recent market activity in the past two months has been a wake-up call to investors. Fixed income securities, traditionally “safe” assets, have lost immense value very quickly. The question now becomes “where can I find income in a low, but rising rate environment?” Fixed income securities are no longer going to be a way to garner sufficient income, as the expected return for bonds has fallen dramatically. Investors will need to search elsewhere. Fortunately, there are alternatives even in this environment, as long as one is willing to redefine their conceptions of safe income.

An Eye Opening Turn of Events

- On Tuesday June 25th, the yield on the 10-Year Treasury Note hit a nearly two year high of 2.6%. This represents a 97 basis point increase since the beginning of May, a mere 38 trading days.
- Since 1991, the average number of trading days it took for the yield on the 10-Year T-Note to rise 100 basis points was 80 trading days.
- From June 15th-19th, the yield rose nearly 40 basis points, the largest one week move in 10 years.
- Interest rates have since pulled back to around 2.5%, a level we expected by the end of 2013.

Since interest rates began their sharp escalation 7 weeks ago, most fixed income products have declined severely in value, as fear and strong selling pressure compounded upon each other, creating a snowball effect on the credit markets. The Barclays US Aggregate Bond Index is on track to have its first negative year since 1999.

This broad market correction may have been a gross overreaction to Ben Bernanke’s comments last week. The stimulus will end and interest rates will rise (albeit, not at the current pace). Tightening Fed policy is a positive sign however, signaling that the economy is in fact healthy enough to creep along on its own without the Fed’s foot on the gas pedal. Some economists, notably Brian Wesbury, Chief Economist at First trust, even argue that too much credit was given to the Fed and QE in the first place, stating that it had little effect on the recent growth of the economy. Regardless, stimulus will end, the economy will chug along, and investors will regain confidence in the market.

Equity Markets: The New "Safe" Asset Class?

Now that the 30 year decline in rates seems to be ending, an entirely new philosophy must now be created, as the search for income need now be considered a search not necessarily for yield, but for total return. Equity markets, therefore, provide an excellent long term investment opportunity, delivering dividend payments and potential for significant price appreciation.

US Markets: Long term prospects for US equities look promising as corporations are more cash rich than they have ever been and PE ratios are lower today than they were in 2008.

Emerging Markets: The spread between US equities and Emerging Markets is at an unprecedented 27% YTD. Emerging Market countries are expected to experience an 8-9% annual GDP increase over the next several years, exhibiting strong potential for equity markets. Funds with attractive valuations such as IEMG and EEM should perform well in this environment.

With 3% dividend yields and the potential for 6-10% price appreciation, this is the new way in which investors must seek to generate risk adjusted income.

Fixed Income: A Ticking Time Bomb

Short Term: We see opportunity only in the shorter term. Goldman Sachs estimates the year end 10 Year Treasury rate to be 2.50%, slightly below the current level. For that reason, the recent spike in rates has increased yields and created an attractive entry point for shorter duration bond funds like CMF and MUB. We also see upside in shorter duration floating rate securities such as bank loans, recently purchasing high yielding BKLN. First Trust, using estimates based on historical data, shows that bank loans would hypothetically be the best performing fixed income asset class in the case of a 1% rise in interest rates, estimating a 5.10% return.

Long Term: Long term bonds and bond funds such as TLT are highly sensitive to rising rates and have lost significant value (5-10%) in the recent months. As interest rates rise, the case will worsen for these securities as funds that have poured into bonds during the last few years begin to leak out.

The End of an Era

Gone are the days of safe, high yielding bonds. New methods to invest and seek return must be devised in order to capture similar benefits to the last 30 years.

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