STATERA

ASSET MANAGEMENT

Commentary: October 2018

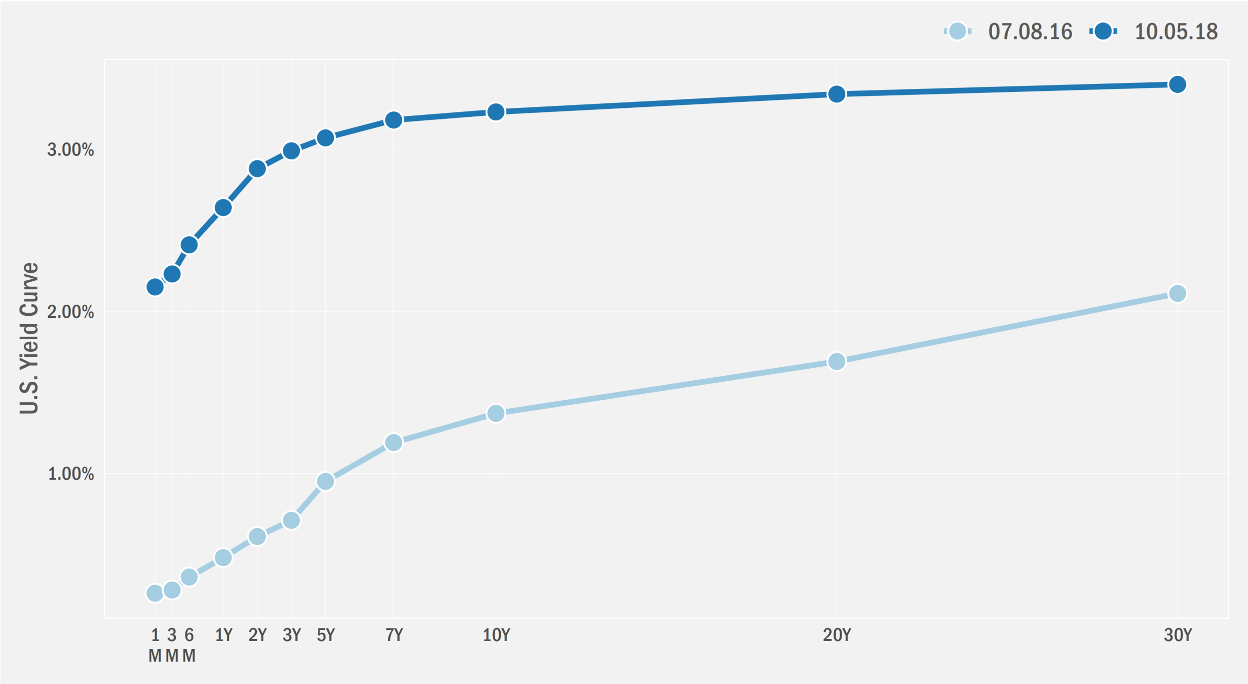
## BONDS BURDENED, NOT BUSTED

A fact of investing, bond prices generally fall as interest rates rise. This happens as holders of existing bonds sporting lower yields (which is the coupon paid divided by the price of the bond) sell them in favor of newly issued bonds carrying now higher going-forward yields. As the prices of older bonds fall, their yields rise. Initiated more than two years ago, a generally sustained upward shift in interest rates has pressured the broader bond market. But, those rate rises have left going-forward yields on fixed income investments materially higher. Further, continued strength in the broader economy has lifted equities, potentially offsetting drops in the fixed income side of portfolios exposed to both major asset classes.

## Yields are Still Rising...

On July 8, 2016, yields on the U.S. 10-Year Treasury bond reached an all-time low of 1.36% and since have marched higher to reach 3.23% as we published this commentary. Discussed in our February and March 2018 commentaries, this shift has come via a less accommodative Federal Reserve, which has set monetary policy on a course toward one more suitable for our now more comfortably healthy and stable economy. While the 10-year yield is one of many across the yield curve (the curve being a chart of the yields across different years to maturity), it is a focal point for assessing the relative state of interest rates. Offering a broader view in Figure 1, interest rates on Treasuries across the maturity spectrum are higher than they were two years ago.

### Figure 1: U.S. Yield Curve Shift

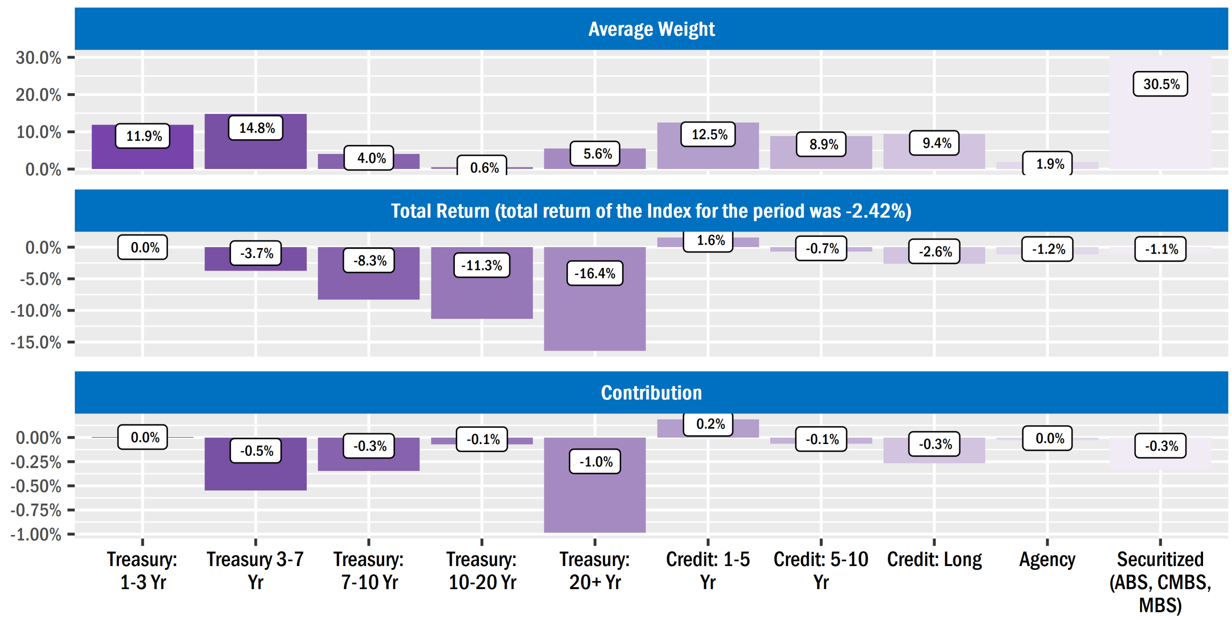



SOURCE: SRCM using data from Bloomberg

## And Returns are Falling...

Also a rule in fixed income investing, the duration of a bond, which is related to the length of time until its maturity, indicates the bond's sensitivity to changes in interest rates. The longer the duration, the greater the sensitivity. As rates have risen, longer-term bonds have seen their prices fall more sharply. In Figure 2 we chart the performance since July 2016 trough of various segments of the U.S. investment-grade bond market. The segments on the left are Treasuries, distinct by maturity, followed by corporate bonds ("Credit"), also segmented by maturity, with agency and securitized bonds (e.g., groups of mortgages packaged into bonds) on the right.

### Figure 2: Components of the Bloomberg Barclays U.S. Aggregate

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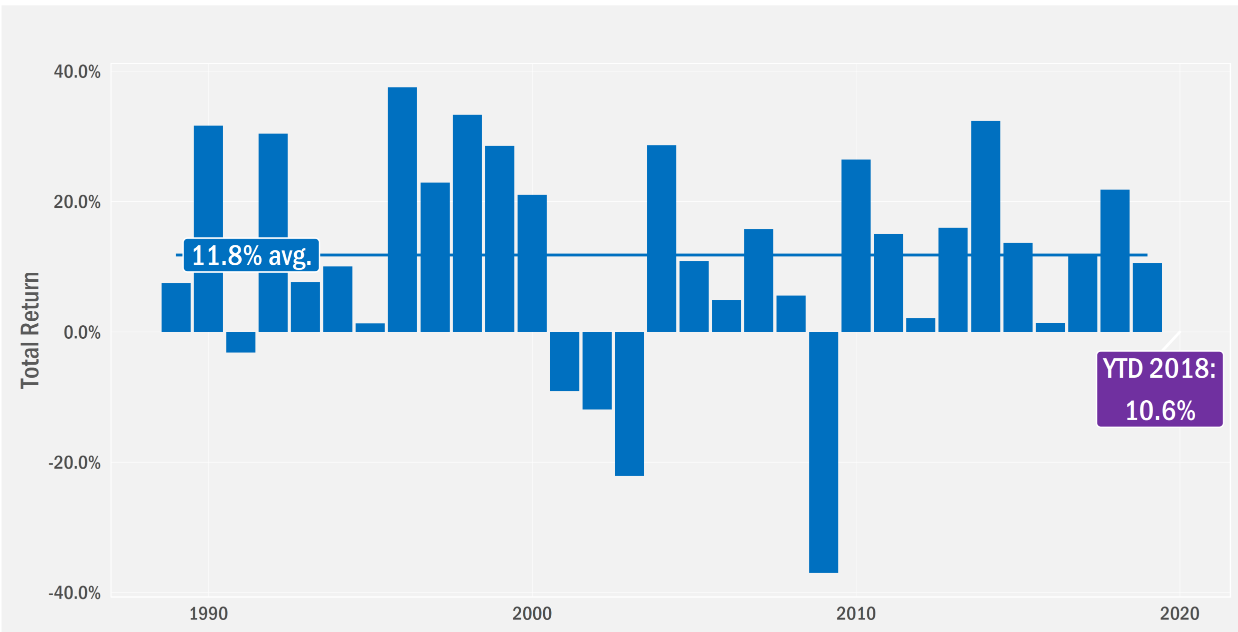
In the chart we show three metrics for each slice of the market: average weight, total return and contribution. Total return incorporates the capital gains/losses and income for each segment. The contribution considers the average weight of the slice in the broader market and reflects its portion of the total return for the market as a whole (the sum of all the individual contributions), which was a loss of 2.4% as of October 5.

From the chart we can see that, while the longer-term Treasuries comprise a relatively smaller portion of the overall market, their much more negative returns boosted their overall negative contribution to the fixed income market's total return. Also clear in the chart is that corporate bonds have fared much better than Treasuries from a total-return standpoint. This performance gap reflects the fact that the broader economy has been strong and continues to strengthen, which is much of the reason that the Federal Reserve continues to lift rates. That strength supports the belief that corporations are less likely to default on their bonds. Theoretically speaking, as that belief draws a greater portion of investors into the corporate bond markets, the prices on those bonds should rise, pressuring yields. Though it reversed at the beginning of this year, that trend since July 2016 has reduced the gap (the "spread") between yields on Treasury and corporate bonds of the same maturity, alleviating some of the pressure from the rising rate environment. Hence the relative outperformance of the latter.

## ...Though U.S. Equity Gains Are Strong

The robust economy (which we will discuss in a bit more detail in our forthcoming Quarterly Market Review) also seems to have bolstered the outlooks for equity investors. Year-to-date, the S&P 500 has gained 10.6% through the end of September, despite a rocky first quarter. That's not too far from the long-term annual average over the past 30 years, and we still have a few months to go before year end.

### S&P 500 Index Annual Total Return

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## Q4 to Go

Of course, it's too early to tell how this year will end in terms of returns for either the equity or the fixed income markets. Unless interest rates turn lower again, despite the now higher aggregate yield, the investment grade market likely will continue to experience the burdens of rising-rates. And U.S. equities were seeing pressure as we wrote this commentary, it would seem in no small part as a result of the continued surge in interest rates. That interplay, set against whatever shifts in macroeconomic trends we will see through year end, shall help determine benchmark gains for 2018.

No matter the outcome, we offer the reminder to all readers that, whatever our individual exposures to investible markets may be, we should seek to be comfortable with the range of outcomes we likely may experience over time. A trusted advisor may provide a source of guidance for investors in determining what that level of comfort may be.

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The Bloomberg Barclays U.S Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. Components of the index include Treasury, Corporate, Agency and Securitized bonds.

The S&P 500 Index measures the performance of the large-cap segment of the U.S. equity market.

One cannot invest directly in an index. Index performance does not reflect the expenses associated with the management of an actual portfolio.

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