Portfolio Perspectives

What Drives Bond Prices and Returns?

A Guide to Understanding Maturity Buckets

In recent years, we have seen the bond market become extremely important to investor portfolios and returns. There was a time in the past when investors only purchased bonds for the income generated by the coupon, but in today's world many advisors have altered their investment expectations to include price performance from bonds as part of their portfolio return expectations. As an example, for the twelve months ending December 5, 2014, the iShares 7-10 Year Treasury Bond ETF (IEF) has had a return of 6.75%, yet its dividend has been just 2.08%[1]. The additional 467 basis points of return came from price performance. Bond returns and interest rates have become increasingly difficult to predict and many economists have been wrong with their predictions about the direction of bond prices this year. I hope the following thought process will help investors understand what I believe is driving prices and returns in the bond market.

The bond market is made up of many individual bonds, each of which has its own defining characteristics. It is important to break the bond market down into maturity buckets because the events that affect one bucket may not affect another bucket. There are four main buckets:

1. Discount notes which are bonds with very short durations, usually less than one year.
2. Short term notes are bonds with maturity dates from one to three years.
3. Intermediate term notes are bonds with maturity dates of three to ten years.
4. Long bonds have maturity dates over ten years and as long as 30 years.

The discount note market tends to follow the target rates set by the Federal Reserve and has very little performance coming from anything other than the interest rate set at time of purchase.

Short term and intermediate term bonds tend to follow economic growth. A popular measure of the demand for these maturity ranges comes from Gross Domestic Product (GDP) growth. When the economy is growing, short and intermediate bonds will fall out of favor and may have low or even negative total return. Alternatively, these bonds will have the largest demand when the economy is slowing or during a recession. Some investors prefer to look at employment data instead of GDP growth, but either way they are measuring the strength of the economy when deciding appropriate pricing for short and intermediate term bonds.

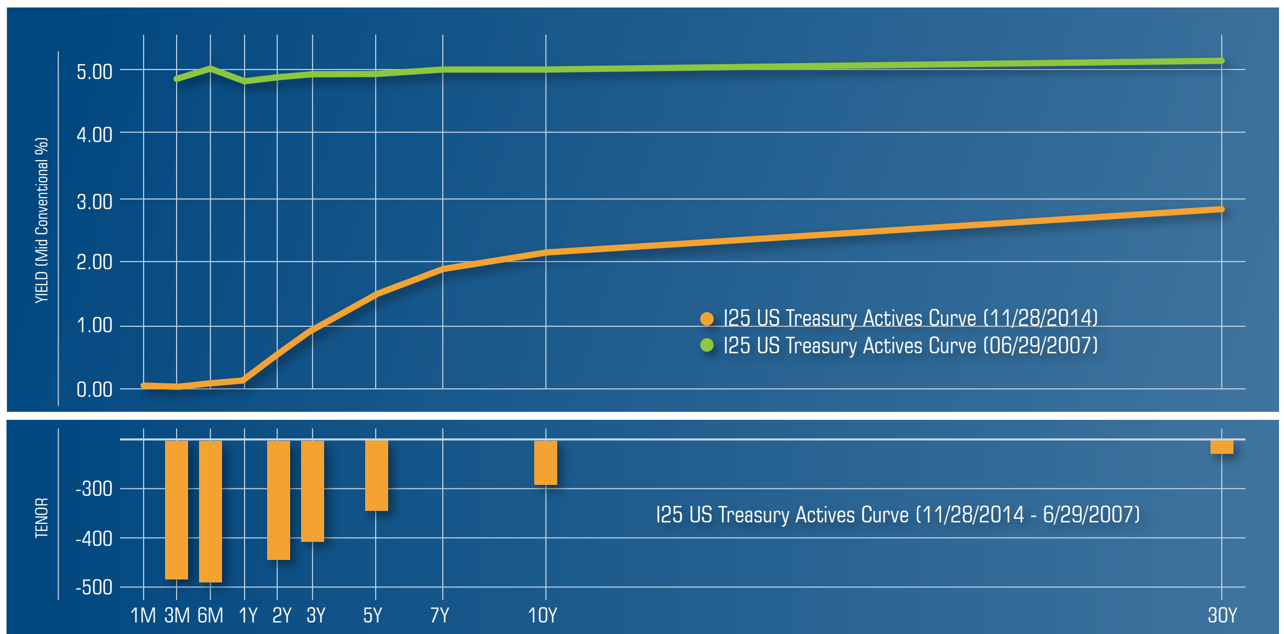
Long term bond valuations, especially maturity ranges of 20 to 30 years, are more commonly priced based on inflation rates and expectations. Generally, if inflation is increasing, long bonds will be out of favor, and if inflation is declining (disinflation or deflation), long bonds will be in favor.

1. Bloomberg

This is not a recommendation to buy or sell a particular security. Please see attached disclosures.

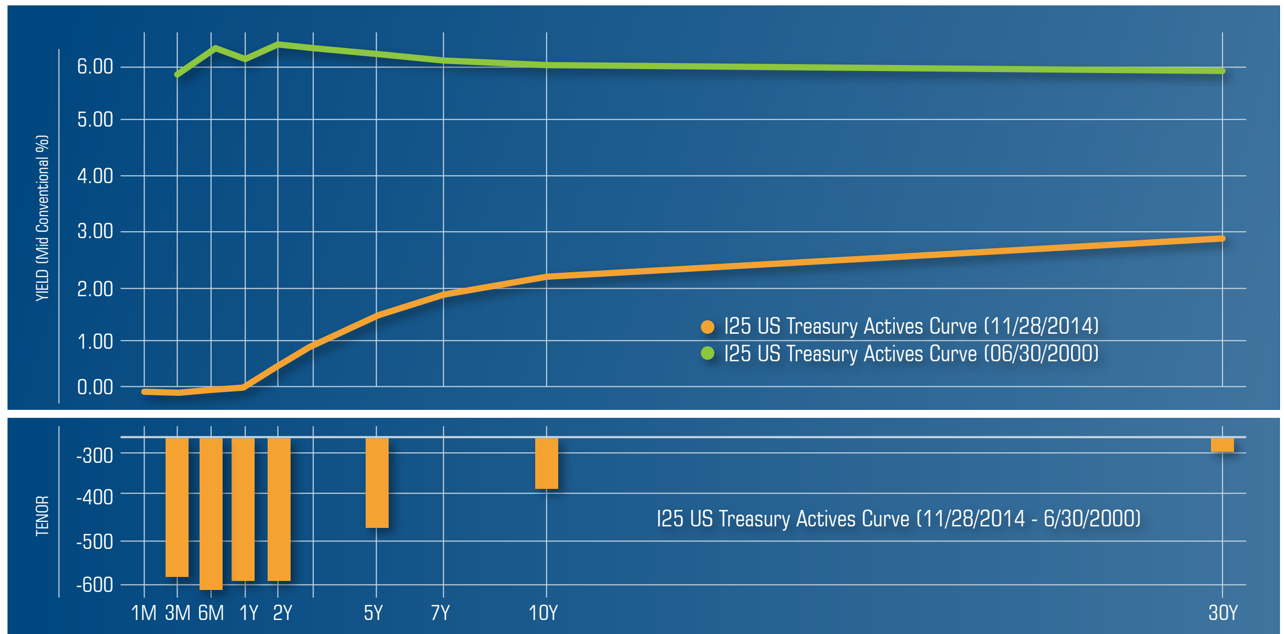
It is not atypical for the unique areas of the bond market to move very differently from each other. This year we have seen the economy strengthen in the second half of the year, which we believe is causing short and intermediate term bond strategies to have declining demand. At the same time, inflation expectations and readings have fallen, increasing demand for long term bonds. It is important for investors to remember the bond market is not as singular or generic as is often reported, and it is increasingly important to think about the bond market by maturity sector. The yield differential between the bond market buckets is referred to as the yield curve. The yield curve can take on numerous shapes and slopes. A normal yield curve is defined as one where long term rates are higher than short term rates, but inverted, flat, and twisted yield curves are all possible.

The graph below shows the yield curve (top line) from June 29, 2007, a reading prior to the recession, compared to the yield curve on November 28, 2014 (bottom line). The bars at the bottom represent the yield differential between the dates. As you can see, though all yields are lower now, the real difference lies in the flat yield curve in 2007 compared to the steep yield curve in 2014.



Source: Bloomberg

The graph on the following page compares the yield curve from mid-2000 to the yield curve on November 28, 2014. In 2000 yields were much higher and the curve was twisted with the two year yield higher than the one year yield, and the 30 year yield lower than both.



Source: Bloomberg

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Mr. Fiebach has had an extensive career in the financial services industry beginning in 1986. Prior to founding Main Point Advisors in 2013, Mr. Fiebach was co-founder, Managing Director, and Chief Investment Officer of Duration Capital Management Advisors, Inc. From 1994 through 2002 Mr. Fiebach built and managed municipal and corporate bond trading at Susquehanna International Group, LP. Mr. Fiebach is nationally known for his publications and presentations including co-authoring *The Handbook of Municipal Bonds* (2008, John Wiley and Sons, Inc.). Mr. Fiebach graduated from Albright College with a BS in Business Administration and Political Science.

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CCM-910