

# The Week

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## **Worth noting**

- With an improving economy and a decline in the risk of corporate defaults, we believe that the biggest risk for fixed income investors is a significant increase in interest rates.
- Long-term investors in U.S. Treasury bonds have done very well over the past three decades as yields have continued to grind lower. Many investors have never experienced a long-term bear market in bonds.
- We look for the 10-year Treasury to trade in a range of 3.25% to 4.50% for the year, with the 10-year Treasury ending the year at 4.25%.
- We are concerned that if the economic recovery picks up steam next year, we could see a rise in rates ushering in a period of negative price performance for fixed income.

## **Are we entering a bear market for bonds?**

There have been several recent news stories that suggest we may be starting a bear market in bonds. With an improving economy and a decline in the risk of corporate defaults, we believe that the biggest risk for fixed income investors is a significant increase in interest rates. As rates rise, bond prices decline, hurting the value for existing bond holders. Alternatively, the potential for stock price appreciation along with the recovering economy also presents investors with additional investment choices.

Treasury securities have been in a rally since September 1981 when the yield on the 10-year Treasury hit a high of 15.8%. Most recently, the 10-year Treasury traded at a yield of 3.75%. Long-term investors in Treasury bonds have done very well over the past three decades as yields have continued to grind lower. Many investors have never experienced a long-term bear market in bonds.

## **Investors have been buying bonds**

Following the credit crisis, many investors gravitated to bonds as a way to help protect the value of their portfolios. U.S. bond funds have seen inflows for 66 consecutive weeks as investors continue to favor the asset class. The strong inflows are of some concern — should investors sour on the asset class and begin removing money from the bond market; it has the potential to move yields substantially higher. At this point, we feel that there is a low likelihood that investors will begin to remove assets from the bond market, as higher yields coupled with low inflation would likely draw in new investors, keeping a “cap” on any potential damage.

## **The Fed is still in “wait and see” mode**

The Federal Reserve left its benchmark lending rate unchanged at its last meeting while reiterating that its key federal funds rate (the interest rate at which banks lend to other member banks) will remain “exceptionally low” for “an extended period”. We believe that short-term interest rates will remain near 0% - .25% through the end of 2010 and possibly into the first part of 2011. We see little reason for the Fed to increase rates as long as inflation is benign and unemployment is at abnormally high levels.

**We do not view this as the beginning of a bear market in bonds but it is likely that the 30-year bull run in bonds is at an end**

Over the course of the first quarter 2010, we have continued to see bond market trends unfold in line with our outlook at the beginning of the year: short-term rates hovering near 0%, a steep yield curve with longer-term rates range-bound. In ASG's "2010 Outlook: A Bumpy Road to Recovery," we looked for the 10-year Treasury to trade in a range of 3.25% to 4.50% for the year, with the 10-year Treasury ending the year at 4.25%. We continue to be comfortable using the same targets at this time. We are concerned that if the economic recovery picks up steam next year, we could see a rise in rates ushering in a period of negative price performance for fixed income. **In our opinion, it is too early to begin reducing fixed income positions.**

**Review duration in fixed income portfolios**

Investors concerned that higher interest rates may be imminent should review the duration of their bonds and bond portfolios. The duration calculation can be broadly used by investors to estimate the likely price change for a bond or portfolio that would occur should market rates go up or down. A bond with a duration of five years would be expected to fall 5% in price for every 1% increase in market interest rates and rise 5% in price for every 1% decrease in market rates. This calculation, however, is simply a rough measure of interest-rate risk. (For a more detailed explanation of duration and price impact, ask your Financial Advisor for the March 9, 2010, *Fixed Income Weekly* titled "The steep yield curve presents investors with difficult choices".)

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- Past performance is not a guarantee of future results.
- Investing in fixed income securities involves certain risks such as market risk if sold prior to maturity and credit risk, especially if investing in high yield bonds, which have lower ratings and are subject to greater volatility. All fixed income investments may be worth less than the original cost upon redemption or maturity. Bond prices fluctuate inversely to changes in interest-rates. Therefore, a general rise in interest rates can result in the decline of the value of your investment.
- Although Treasuries are considered free from credit risk they are subject to other types of risks. These risks include interest rate risk, which may cause the underlying value of the bond to fluctuate, and deflation risk, which may cause the principal to decline and the securities to underperform traditional treasury securities.

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