Fixed Income Insight
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September Proves to be Good Month for Bonds: Will the Momentum Last?

Bond investors found September to be much more to their liking than the first two months of the quarter. Following a steep readjustment in bond yields that began in mid-June and continued through Labor Day, bonds gained during September while the Dow readjusted downward. The recovery in bond performance wasn't enough to offset the rise in bond yields during the third quarter, but it did suggest that the worst of the bond rout appears to be over for the year. Ten-year Treasury Bonds closed the month breaking through 4% to land at 3.95%, still above the low yield mark of 3.11% reached on June 13.

Improving economic prospects drove bond prices lower and stocks higher during much of the second quarter. Coming off a first quarter growth rate of 1.4%, the second quarter GDP posted a 3.3% annual growth rate. Consistent with positive growth, a number of recently released indicators show that the economy is chugging along in positive territory at a low-to-moderate pace aided by solid car and truck sales and a robust home sales market. In reaction to the good news, bond yields during the first two months of the third quarter moved sharply upward as a result of increased federal budget deficit concerns coupled with declining consumer confidence. In addition, bond investors demanded higher yield premiums just in case inflation peeked into the picture. But like a cautious football team on the offense deep in its own territory and worried about a potential mistake, the Fed is guarded against a sudden slip in the economy which would move the nation back into recession or cause a bout with deflation. Defensively, it continues to hug the unusually low 1% lending rate.

Bond returns are in the plus column year-to-date; however, the biggest gains seem to be coming from the corporate bond sector, which has seen credit spreads narrow. According to the Lehman Brothers bond indices, the Intermediate U.S. Government Bond Index returned nearly 2.5% year-to-date, while the Intermediate "A" rated corporates have registered a total return slightly over 6%. Intermediate "BBB" rated corporate bonds have fared even better with a more than 9% total return. The Mortgage-backed securities Fixed Rate Index had a positive month in September, but appeared relatively weak year-to-date with a return just above 2%. Lastly, intermediate municipals, while unadjusted for their tax advantage, still emerged with year-to-date returns hovering around 4%.

Looking ahead to the fourth quarter, market statistics indicate an economy that perhaps will coast on the heels of consistent personal spending activity. While low borrowing rates may continue to fuel activity, debt build-up could become a much bigger issue if job growth does not materialize and consumer confidence weakens. In light of current conditions, we expect that the Fed will keep its lending rate at 1% for the rest of the year. We also believe that investors will be skittish about intermediate to long term bonds that try to fall below the June 13 yield levels. Readjustments during the quarter are more apt to stay in a relatively narrow range until economic conditions and sentiment become more firm.

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