

“BOND BUBBLEOLOGY”

With viewers to attract, readers to sustain, and advertising to sell, one can understand the media’s penchant for sensationalizing the news of the day. Competition in the financial media has exacerbated this inclination. Over the past decade, market pundits seem fascinated with placing a “bubble” label on various sectors of the market that perform exceedingly well. Having recent memories of the dramatic rise and subsequent decline of the internet and real estate sectors, one can understand media and investor nervousness about potential bubbles forming in our markets, for the aftermath, as we all well know, can be quite unpleasant. However, one should be careful with haphazard assignment of “bubble” to all outperformance as overwhelming evidence is necessary to warrant the term.

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Bubble History

Long-time readers may recall a certain fascination with historic incidences of herd behavior and financial mania, most often referenced by the Dutch experience with Tulipmania. During the Dutch Golden Age, the price of coveted tulip bulbs skyrocketed beyond belief, as some single bulbs fetched up to ten times an average worker’s annual income. In 1636, a futures market developed and large up-front premiums were required for the contracts to buy end of the season bulbs. The spectacular peak was reached in 1637 with reported trades for a single tulip fetching over four thousand florins, a sum equal to an average family’s

annual income in today’s dollars. The ensuing crash was equally as spectacular. Plummeting prices destroyed the wealth of most speculators and panicked tulip owners sought government aid. The Netherlands government responded by enabling anyone to void a futures contract by payment of a ten percent fee. Needless to say, the collapse of the market led to an economic downturn in the years that followed.

Current Bond Bubble?

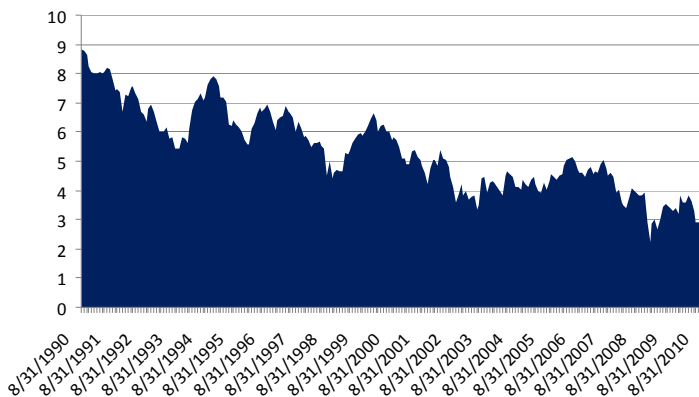
Our better known, more recent brushes with bubbles and their resulting brutal crashes had some very clear similarities. Valuations became so stretched that new metrics were created. Rather than value an internet stock on its P/E multiple or revenue multiple, the number of eyeballs or “stickiness” of visitors to one’s site became acceptable barometers. At the top of the real estate market, the ratio of the average home price to average annual income reached heights that most felt were beyond reach. Rampant speculation is also a telltale sign of excess and potential bubbles. To judge this requirement, I often like to invoke the Mom Rule. If I catch my mom and her friends discussing or flipping real estate, internet stocks, or the like, the mania has reached all potential participants. This signal should send one running for the exit.

In today’s bond market, many are questioning the emergence of a bubble, as voracious investors continuously purchase bonds with ever diminishing yields. Certainly, benchmark Treasury yields at approximately ½% for

two-year notes and only 2 ½% for ten-year notes do not provide one with much potential return. Yet, does this necessarily indicate extreme, bubble-like overvaluation?

10 Year Treasury Yields

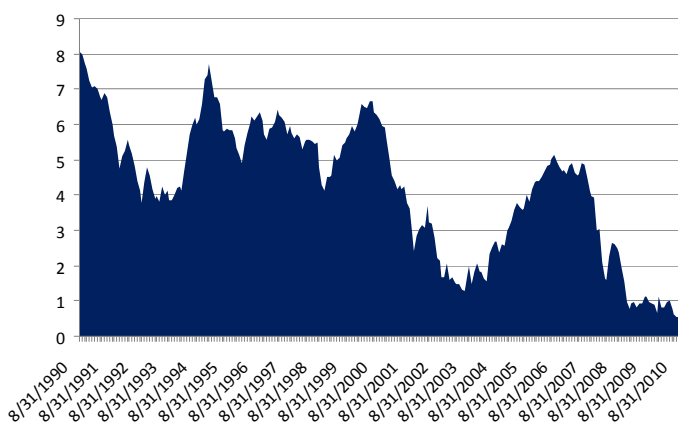
Aug 1990 to Present



Using the 10-year Treasury as a broad representation of current market thinking, a yield of 2 ½% certainly appears subpar when compared to the average yield of approximately 5 ½ % over the past thirty years. This yield, though, is comprised of a required real return and the inflation expectations. Historically, the real interest rate component has ranged between 2% and 3%. During economic difficulties and the near-zero cost of money, one is easily justified using the lower figure.

2 Year Treasury Yields

Aug 1990 to Present



Coming out of the recession, with deflation talk still in the air, inflation expectations have been significantly muted. The market-implied inflation rate, the difference between the nominal Treasury

yield and the TIPS yield, is currently around 1 ½% for the next ten years. Thus, one might consider fair value for the 10-year Treasury to be 3 ½% (2% real interest rate plus 1 ½% inflation expectation). With today's 10-year note yielding a little over 2 ½%, this analysis reveals that Treasuries may be overvalued by 75 to 100 basis points. A moderate overvaluation of this magnitude does not seem significant enough to indicate the formation of a bubble in benchmark Treasuries.

Credit Markets

The bond market, having recovered so strongly from its late 2008 and early 2009 depths, no longer provides the wide yield compensation for accepting risk. At the financial market nadir, investment-grade corporate bonds sold for over 8% above similar maturity Treasuries, while high-yield investors received a 20% yield pick-up. With spreads having normalized over the past 2 years, a downturn in the economy, or the much feared double-dip recession, would push yield spreads wider and hand investors capital losses as prices come under pressure. Conversely, should the economic recovery firm and real interest rates rise, the elevated duration risk of most bonds would also result in capital losses for bond investors. Granted, the healthier economy would improve corporate profits and reduce credit risk. Thus, yield spreads may compress and slightly offset the higher general level of interest rates, but the impact would still be substantial.

Investor Risk Tolerance

Does this market environment necessarily define a bond bubble? Benchmark Treasury yields are greatly reduced, and when coupled with compressed yield spreads for corporate, mortgage-backed, and municipal bonds, investors are left with little room for error. However, we would argue that it is unlikely that a bubble has emerged. More likely, the convergence of investor fear following the equity troubles in 2008 and the current challenges facing our economy, coupled with changing demographics

and the need for fixed income, provide much of the explanation for our current yield opportunities. Furthermore, in the case of corporate bonds, corporations are arguably the healthiest part of our economy, having been well-prepared for the recession and having drastically improved their balance sheets over the past two years. Therefore, the necessary yield compensation required by investors should be much reduced when compared to the riskier environment of

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2008. In addition, the Federal Reserve’s massive purchases of mortgage-backed securities (\$1.25 trillion), U.S. Treasuries (\$300 billion), and federal agency bonds (\$200 billion) left corporate bonds as the most attractive alternative in the investment-grade universe.

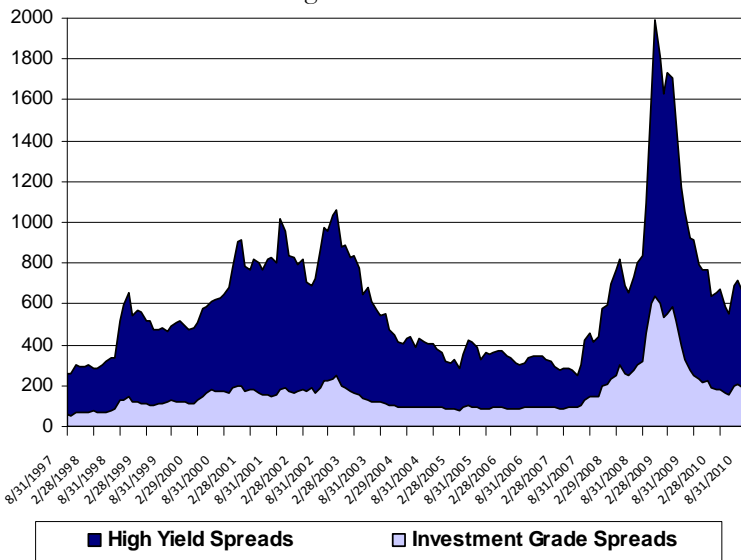
appeal to an absolute yield of 2%, yet when compared to money market and CD alternatives, the decision is more understandable.

No Bubble ≠ No Risk

Dismissing the bond bubble theorists does not equate to a stable, comfortable investment option. Risks in the bond market are running well above normal. Typically, the savior in the fixed income world is the near certain receipt of

the monthly, quarterly, or semi-annual coupon. The more ample the periodic coupon payment, the greater the cushion against adversity. Of course, the acceptance of riskier assets is greeted with a larger yield component, but it is the benchmark or base rates available today which significantly amplify the risk element in bonds. This duration risk is at an extremely elevated level. The 30-year Treasury bond, absent of credit risk unless one believes the U.S. government will default, typically has a duration of 12 or 13 years.

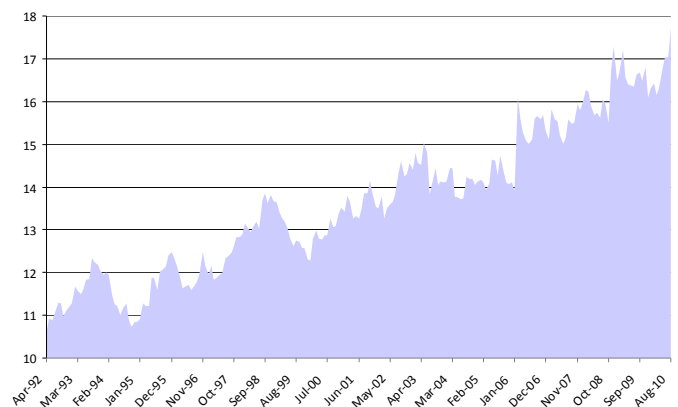
Investment Grade and High Yield Spreads
August 1997 to Present



Monetary Policy

Monetary policy has had a dramatic effect in the bond market as the Federal Reserve’s near zero interest rate policy forces investors to search for yield, creating an increased demand for risky assets and reducing the yields in all sectors of the bond market. This point, intended by the Fed, makes a strong case for the *relative value* trade. Many investors realize that there is limited

US Treasury 25+ Year Modified Adjusted Duration
April 1992 to Present



At the low absolute yields in today’s bond market, which have pushed down the 30-year bond yield to near 3 ½%, duration has surged to over 18 (an increase of approximately 50%!). Should rates increase by 1% over the next year, this translates into a potential principal loss of 18% on a “risk-free” Treasury bond. Long rates backing up to an average 6% or 7% spells even

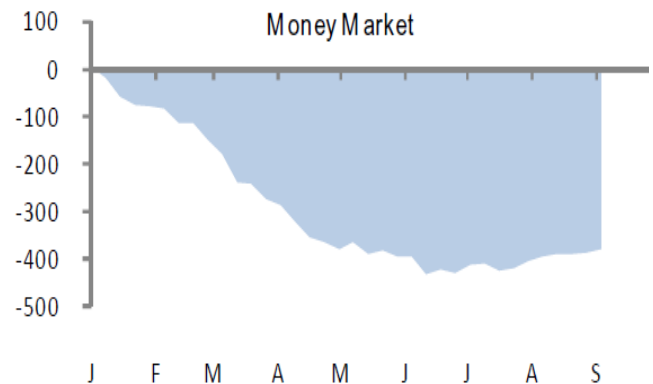
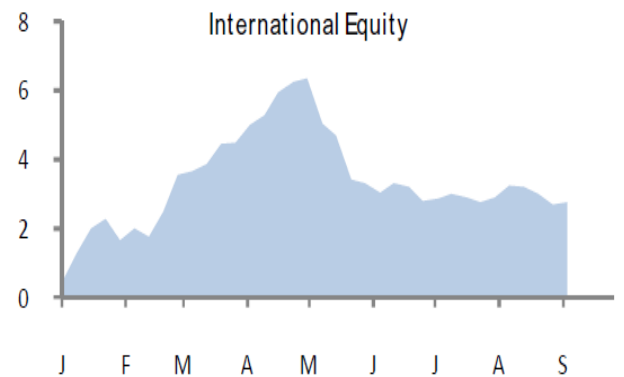
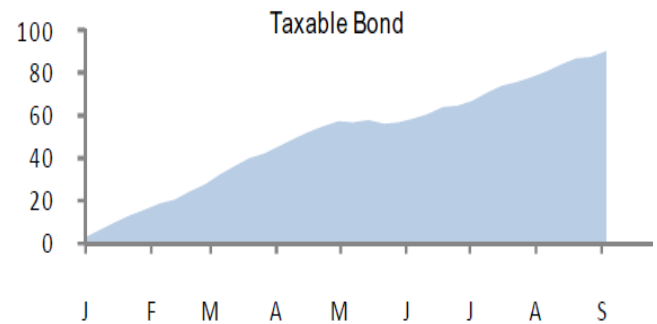
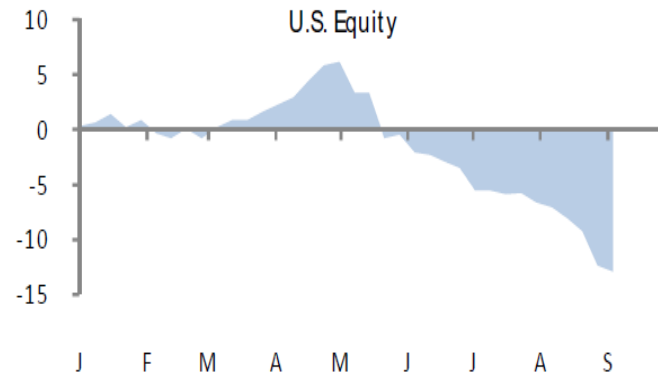
greater capital losses, as there is scant coupon income to offset the rising rates. Corporate, mortgage-backed, and municipal bonds face slightly reduced capital losses should rates rise as their initial higher coupons and yields translate into lower durations which would serve to mitigate losses due to rate increases.

Conclusion

There is no question that the financial market landscape has changed. So, too, have investor attitudes towards risk. Government programs and policies, demographic shifts, and economic outlooks have combined to alter asset allocation decisions. But these factors have not created a bubble. Quite simply, many investors have opted for a historically less risky portfolio composition. We have not witnessed the rampant speculation, the recalibration of valuation methodologies, and the other elements most often witnessed during a financial mania. The lack of evidence for the existence of a bond bubble does not mean, however, that changing attitudes and economic fortunes won't produce severe movements in the bond market. With the low absolute yields and greatly reduced yield spreads, most professional and retail investors may be underestimating the high degree of risk in our bond market. Similarly, elevated risk in the market does not equate to the avoidance of bonds. Depending upon one's risk tolerance and investment goals, some sectors of the bond market may still make sense. At these low relative yields, and following the massive inflows into the bond market, caution must be employed and risks carefully evaluated.

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2010 Cumulative Weekly Flows



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