From right to left:

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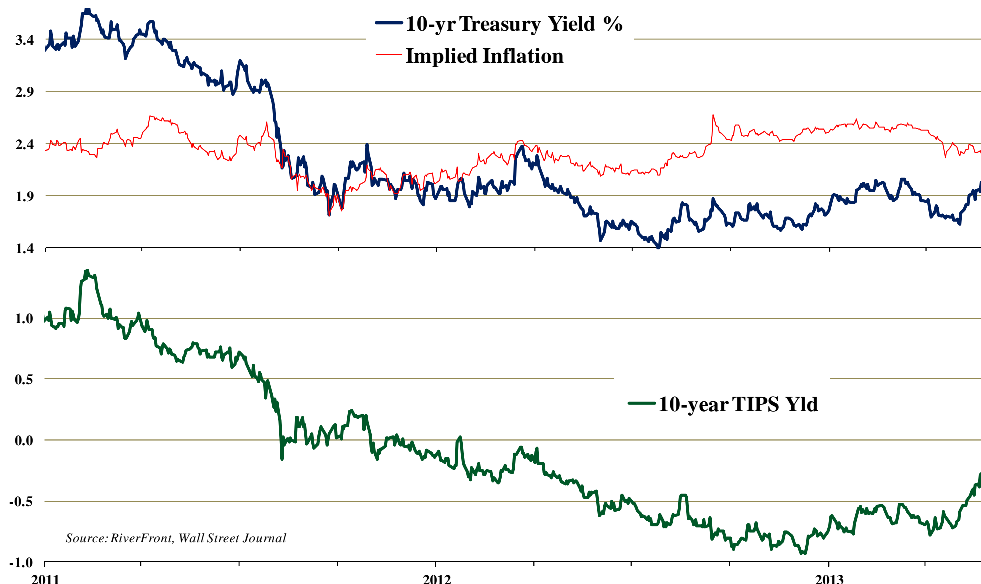
We believe the Federal Reserve will be debating the timing of 'tapering' bond purchases for many months, and tame inflation pressures will allow them to remain accommodative for longer. However, we have no interest in owning long-dated investment grade bonds, which we see as a 'return-free risk' investment.

The Bond Investor's Dilemma: Heads You Lose, Tails You Still Lose

In early 2011, the US housing sector had not clearly bottomed, auto sales were running roughly three million units per year less than today, and the unemployment rate was about two percentage points higher. Despite this fragile domestic economy, 10-year interest rates were around 3.5% as our chart below shows. 10-year Treasuries fell into their current trading range of 1.5 – 2.5% in the summer of 2011, amid a crisis of confidence in Europe and a further commitment by the Federal Reserve to purchase longer-dated bonds. After nearly two years of sluggish growth in the US, a return to recession in Europe, weaker growth in the developing world especially in China, and plentiful monetary support from the world's central banks, we have become accustomed to rates being this low.

Heads you lose: If rates remain low, then Treasury bond investors are taking considerable interest rate risk for zero return over inflation. TIPS (Treasury Inflation Protected Securities) yields are close to 0% despite their recent rise (green line in the bottom panel of the chart below).

Tails you lose: If long-term interest rates eventually return to early-2011 levels, as we expect, then longer-dated, low-interest bearing bonds will see losses. A 10-year Treasury will lose roughly 9% in value for every 1% rise in interest rates.



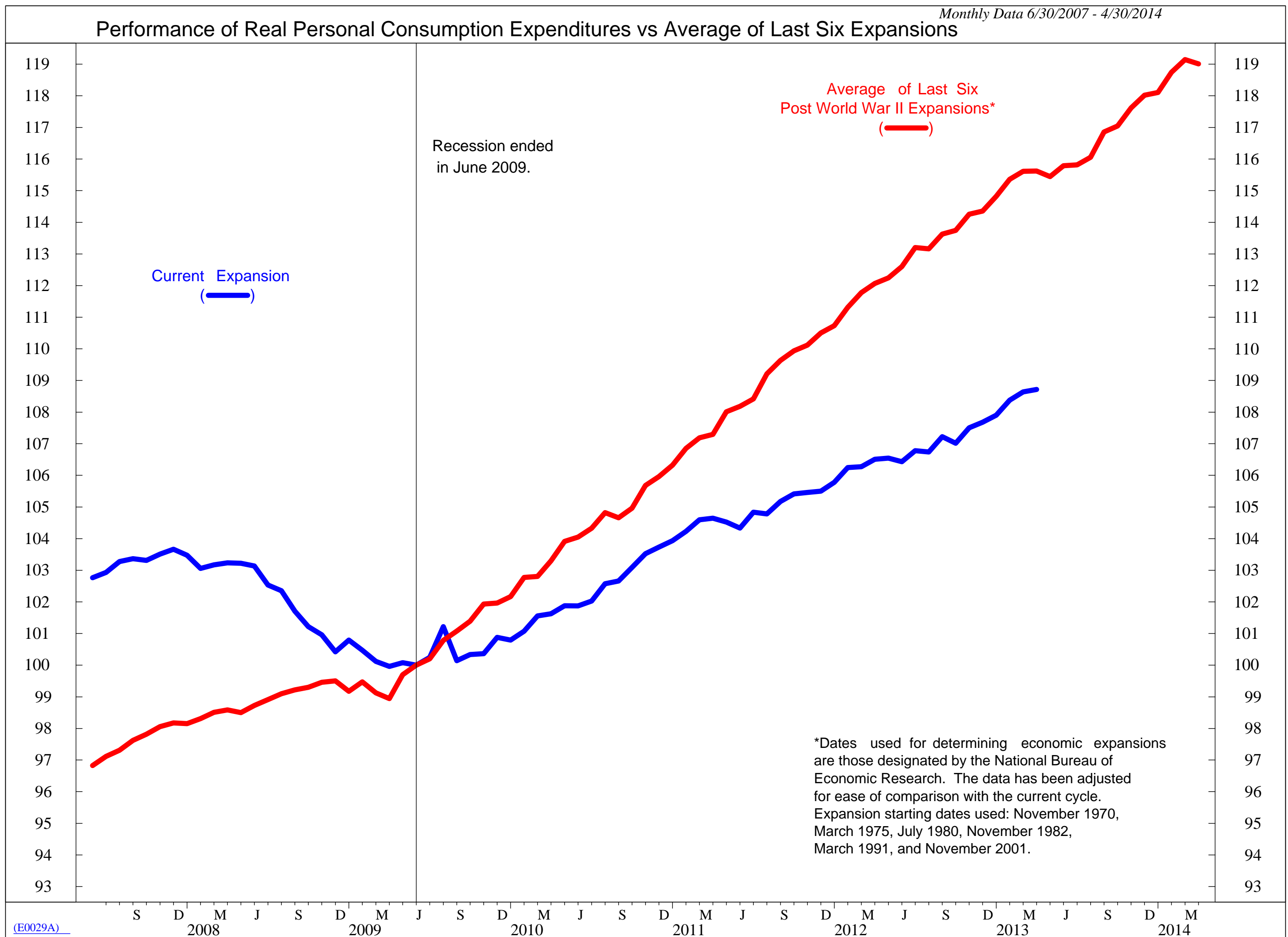
Past performance is no guarantee of future results.

Long-term interest rates are rising even as inflation expectations fall. We think the reason is greater optimism about sustainable growth rather than fear of higher inflation. We can gauge inflation expectations by calculating the difference, or spread, between Treasury yields and TIPS yields (which are inflation-adjusted yields). Inflation expectations fell in May even as nominal yields rose: the current 10-year Treasury yield of 2.16% is up 0.52

percentage points from its May 2nd year-to-date low; implied inflation fell 0.08 percentage points to 2.24% in the same period. Lower inflation expectations may partly explain the recent decline in gold prices. Over the same period, real yields rose 0.60 percentage points to a still negative (financial repression at work) 0.063%. Rising real yields suggest an expanding economy's growing demand for money.

Last week's preliminary report for first-quarter US GDP showed the economy grew at a 2.4% inflation-adjusted annual rate, below its post-war average of 3.2% and between RiverFront's baseline and optimistic expectations for 2013. Personal consumption expenditures (PCE), roughly 70% of the economy, were revised upward from the advance report by 0.2 percentage points to a 3.4% annual rate, the highest since 2010. We think this reflects an economy in which the private sector is growing strongly enough to offset the slowdown in government spending. We believe this trend can persist but as the Weekly Chart shows, the growth of personal consumption is well below average when compared to the last six US economic expansions. Thus, we believe the Federal Reserve will be debating the timing of 'tapering' bond purchases for many months and tame inflation pressures will allow them to remain accommodative for longer. However, we have no interest in owning long-dated investment grade bonds, which we see as a 'return-free risk' investment.

THE WEEKLY CHART: CONSUMER RECOVERY IS SUB-PAR BUT PERSISTENT



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