UNITED FINANCIAL

Portfolio Construction

August 2014

Mixed signals from the bond market

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Bonds have been the dark horse this year, charging out of the gate in January and advancing briskly through July, despite an improving economy and the slowing of bond purchases by the U.S. Federal Reserve. Last December, economists polled by Bloomberg News were expecting the yield on 10-year U.S. Treasury bonds to climb to 3.41% by the end of 2014. Instead, by the end of July, treasuries yielded just 2.49% while the 10-year Government of Canada Bond Index yielded a meagre 2.16%. Low bond yields are often seen as a predictor of weaker economic times ahead. Yet the North American economy appears to be on a solid footing with sustained improvements seen in employment, foreign trade and other critical areas. Let’s take a look at the drivers of the recent bond market strength and examine whether we can safely dismiss the low yields as a false signal.

The first quarter contraction in the U.S, driven by extreme weather, took many by surprise and should help to explain the decline in yields. However, the strong bounce back in gross domestic product in the second quarter and the continued reduction of monetary stimulus has failed to produce the higher yields that one would expect. Declining bond yields in Europe, spurred by the European Central Bank’s efforts to support the Eurozone’s fragile economy, have indirectly suppressed other nations’ yields thanks to the globally integrated nature of financial markets. Large investor flows have also temporarily distorted yields. For instance, data from the U.S. Fed show that American pension funds, on average, have been rebalancing out of high-performing equity markets and increasing bond allocations to lock in recent gains and reduce risk. Finally, heightened geopolitical risks in the Middle East and Eastern Europe have also contributed to an increase in demand for government bonds by investors seeking a safe haven.

More often than not, capital markets take into consideration all available information along with present and potential future events, and we should be careful not to ignore the signals. For instance, lower treasury yields may be correctly discounting a slowdown in North America that could be linked to the weakness in Europe. Or perhaps bond market participants may be accurately pricing in a potential contraction fuelled by further geopolitical disruptions and disasters. Consider also that the Fed has the ability to raise short-term interest rates as well as a large supply of long-term bonds – accumulated through quantitative easing – which it could sell back into the market to push longer-term yields higher if desired. Fed chair Janet Yellen has not yet engineered meaningfully higher yields and this is indicative of the Fed’s still-cautious stance.

We believe the bond market is not telling the entire truth as yields continue to be kept artificially low by a number of unusual factors. However, there are reasons to believe it is not exactly lying either. We consider today's low yields a reason to be cautious, but certainly not fearful. We expect the global economy to continue improving at a modest pace, leading to higher long-term bond yields in the coming quarters. We are comfortable with owning stocks in this environment and continue to rely on company fundamentals to generate returns for our clients.

Combined top 15 equity holdings as of July 31, 2014 of a representative balanced United Financial portfolio with alpha-style equity exposure:*

1. Baidu	6. State Street	11. Microsoft
2. Materialise	7. Citigroup	12. UnitedHealth Group
3. Simon Property Group	8. American International	13. Equity Residential
4. Schlumberger	9. Johnson & Johnson	14. Intel
5. Goldman Sachs	10. Norfolk Southern	15. Boeing

Combined top 15 equity holdings as of July 31, 2014 of a representative balanced United Financial portfolio with value-style equity exposure:*

1. Covidien	6. Grupo Televisa	11. UnitedHealth Group
2. Willis Group Holdings	7. Phillip Morris International	12. Simon Property Group
3. Vodafone Group	8. Boeing	13. BP Amoco
4. Noble Corp.	9. Citigroup	14. American International
5. Microsoft	10. Schlumberger	15. Goldman Sachs

*Approximately 37% fixed-income, 7% enhanced income, 49% equities and 7% global real estate.

To see the top 15 holdings of the individual United Pools or of the United equity Alpha mandates, please visit the United Financial web page by right clicking on this link and selecting "open web link in browser": http://www.assante.com/wp/optima/financials.jsp#united15.