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**Few Places to Hide with Bonds**

Friday April 9, 8:05 pm ET

By J.D. Steinhilber, AgileInvesting.com

The bond market suffered its worst one-day decline in eight years on April 2, with the yield on the 10-year Treasury note rising a quarter of a percentage point following the strong March employment report. Intermediate-term yields have risen almost a half point in the past two weeks.

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The bond market may be reenacting its performance of last summer when the 10-year Treasury yield rose 50% in less than three months. Between June 13 and September 2, 2003, the 10-year Treasury yield rose from 3.1% to 4.6%, and fixed-income investors learned that stocks aren't the only investments that can suddenly lose 10% of their value.

The spike in yields last summer should not have been surprising. In the

first half of 2003, yields became excessively depressed due to a sluggish post-bubble, post 9/11 economy, the war in Iraq, and a heavy dose of rhetoric from Greenspan and Co. about the threat of deflation and the possibility of the Fed buying Treasury bonds in the open market. By Labor Day, conditions were very different. The Fed had recanted its suggestion of unconventional policy measures, the war was over, and the economy was in strong recovery mode. In fact, it was in the process of registering its fastest rate of GDP growth in 20 years.

What was surprising was that after peaking around Labor Day, yields began to trend back down, despite accelerating economic growth and a host of factors traditionally negative to the bond market, including a falling dollar, soaring commodities prices and huge budget deficits. After reaching 4.6% on September 2, the 10-year Treasury yield traded between 4% and 4.5% through February 2004 and then in early March actually dropped below 4%, falling all the way back down to 3.6%.

The strength of the bond market in the first quarter of 2004 defied the expectations of strategists, who underestimated two key underpinnings of bond prices -- massive buying by Asian central banks (which are motivated by currency and trade issues rather than investment merits) and the prevalence of yield-curve

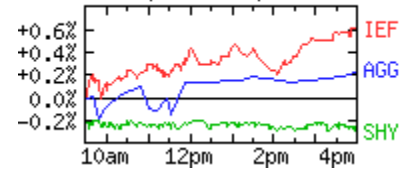
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traders taking advantage of the ability to borrow short-term at 1% and invest intermediate-term and long-term at 3%-5%. Both of these forces will continue to support bond prices, although, most likely, to a lesser degree. The yield-curve traders will recognize that with pressure building on the Fed to raise rates, time is running out on the so-called "carry trade". As for the Asian central banks, surely their appetite for U.S. bonds is not infinite. After all, the central banks of Japan and China have already increased their holdings by 50% over the past year to \$700 billion, which is nearly 20% of our outstanding federal government debt.

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A more important influence may begin to unsettle the bond market, namely the perception of inflation, which historically has been the primary determinant of intermediate and long-term bond yields. Bond investors have had an overly benign view of inflation of late in large part due to their reliance on the Consumer Price Index as the primary gauge of inflation. In a typical example of how the CPI data is used to justify the lowest bond yields in two generations, after Friday's strong jobs report, a strategist on a widely watched weekly investment program stated that since core CPI was only 1.1%, 10-year Treasury bond yields in the 4% range were reasonable.

The problem with this is that CPI is a flawed measure insofar as it significantly understates inflation in two major areas of expenditure -- housing and health care. CPI's record of housing increases trail those of housing specialty agencies Freddie Mac and Fannie Mae, and health care in the CPI is weighted far below its actual GDP proportion.

All of this begs two key questions. What is a more accurate estimate of inflation and what is fair value for bond yields? On the first question, an inflation estimate of 2.5% seems appropriate. This rate adjusts for some of the above-mentioned deficiencies in the CPI calculation and is in line with the 2.5% spread between conventional and inflation-protected intermediate-term Treasury bonds. The spread between conventional Treasuries and TIPS provides a useful market gauge of inflation expectations. Using a 2.5% inflation assumption and based on the fact that "real" (i.e. net of inflation) yields on intermediate-term government bonds have historically averaged 3%, an appropriate yield on the 10-year Treasury appears to be 5.5%, not the current yield of 4.15%.

So despite Friday's sell-off, the risk/reward relationship in the bond market still looks very poor. It may be that bonds are able to avoid their day of reckoning until the Fed begins to raise interest rates (probably this summer), but I wouldn't count on it.

What is a fixed-income investor to do in such an environment? A typical strategy in a rising rate environment is to keep maturities as short as possible. But with short-term rates at such abysmally low levels, even short-term fixed-income investments are likely to generate negative total returns over the balance of 2004. Adjustable rate and foreign bond funds, as well as interest-only (IO) securities, appear more attractive.

Regrettably, ETF investors have very few attractive options, given that there are only six fixed-income ETFs currently on the market. Two of these ETFs - the Lehman 7-10 Year Treasury Bond Fund (AMEX:[IEF](#) - [News](#)) and the Lehman 20+ Year Treasury Bond Fund (AMEX:[TLT](#) - [News](#)) are decidedly unattractive and would be better considered as short candidates. The Lehman 1-3 Year Treasury Bond Fund (AMEX:[SHY](#) - [News](#)) is less interest rate-sensitive given its duration of 1.7 years, but will probably generate a flat to negative total return over the balance of the year due to its low current yield of 1.6%. The Lehman Aggregate Bond Fund (AMEX:[AGG](#) - [News](#)) and the GS InvesTop Corporate Bond Fund (AMEX:[LQD](#) - [News](#)) offer higher current yields, at 3.0% and 4.9%, respectively. However, their longer durations (4.3 years for AGG and 6.6 years for LQD) subject them to the risk of price declines in excess of 5%, which would wipe out their yields. The Lehman TIPS Bond Fund (AMEX:[TIP](#) - [News](#)) offers some protection against

inflation, but the inflation adjustments are based on the CPI so they will likely be below actual inflation in the economy.

J.D. Steinhilber is the founder of [AgileInvesting.com](http://AgileInvesting.com), an investment advisory web site that recommends ETF-based portfolios.

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