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FI Weekly Brief

Bill Gross' monthly commentary talks about the once in a 100 year events, occurs every 5-7 years in today's market. Frankly, the whole economy would have collapsed and there should be social unrest in most parts of the world, had the central banks not come to the rescue. And I use the term rescue, as in the sustaining of the current fiat currency, reserve bank system.

Skimmed "Lords of Finance" and it revealed the central banks dominant role in actions leading up to WW1 and WW2. We can't dismiss their active involvement and effect on the market, and political policies which are conducted behind closed doors.

It is well known to us now, fixed income market will see bond value fall incrementally, as it is above par. Bond valuation principle explains principal loss whenever a trade sells above par. Surely, the yield may be higher than other non-fixed income security, but the large scheme is one that is destined to have a falling bond value.

We participated in a few bond simulation exercises, and the outperformance we saw in the past 5 years, post-Lehman is attributed to the rise of bond prices from the bottom. However, now bond prices are selling at a premium. We have seen more credit issued by high yield corporate entities. With interest rates so low, 2012 saw a record corporate issuance and many were high yield issues. This is great for bond funds, who try to buy high yielding bonds, but what happens in the next few years as maturity rolls around?

1) Investors will be seeing scant, low yielding bonds like today
2) Corporate bond issuers may enjoy the low yields for now, but can they roll those bonds later?

So one could short the bond indexes, and there is more noise of rate cuts coming sooner than the 2015 projection provided by the Fed in 2012.

Fixed income provides 1) capital preservation, 2) steady income, 3) backed by corporate assets if it is corporate bonds, and the promise of the government for sovereign bonds, 4) diversification for mixed portfolios, 5) anchor for fund value since the value doesn't fluctuate as much as equities, 6) hedge for economic risk (not corporate, but safe haven i.e. US, Japan, German).