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Bond Exodus Cometh

The big story in the fixed income market is the mass exodus from the index credit funds, to specific, individual bonds. It is now mainstream news that the credit market is selling at a frothy premium, so large institutions such as Blackrock are moving out. Surprisingly, Pimco's Total Return Fund has moved away from mortgage bonds to Treasury bonds, which were the object of criticism by Bill Gross a year earlier. 1) Why did he move back into the low yielding Treasuries, and 2) other institutional investors pull out of bonds?

1) No place to put the capital at current prices in the credit space. Of course, Bill Gross' investment vehicle is a bond only fund, so he might as well put the capital into the safest bet. He probably sees the credit bubble popping soon this year. Some funds will return less than coupon, and rightly so, since they are selling above par.

2) Other investors running a blend portfolio (fixed income + equity) may be seeing some opportunities in the equity space. We believe the current US economy has improved YoY, but there is still weakness. The real estate pricing recovery does not substantiate a recovery in the underlying fundamentals. We believe a lot of the equity, real estate appreciation is a result of 1) liquidity from QE, 2) capital allocation from fixed income to equity, 3) rosier expectation of the weak economy with misleading metrics.

   There is a lot of skepticism over corporate earnings, with figures such as corporate taxes collected by the government not growing in par with reported earnings, which implies accounting and one-time impairments, propping earnings, and renewed concerns of Europe imploding under the weight of the crisis impairing future earnings forecast.

   We believe the US market will hold strong at +10% returns, but not because the economy is stronger, rather inflated asset pricing spurring on lofty expectation. We believe high yield bonds will return +5% returns, but some index funds will return very low 1-2%, or possible negative returns for Treasury funds. In other words, don't anticipate +10% returns in bond funds.