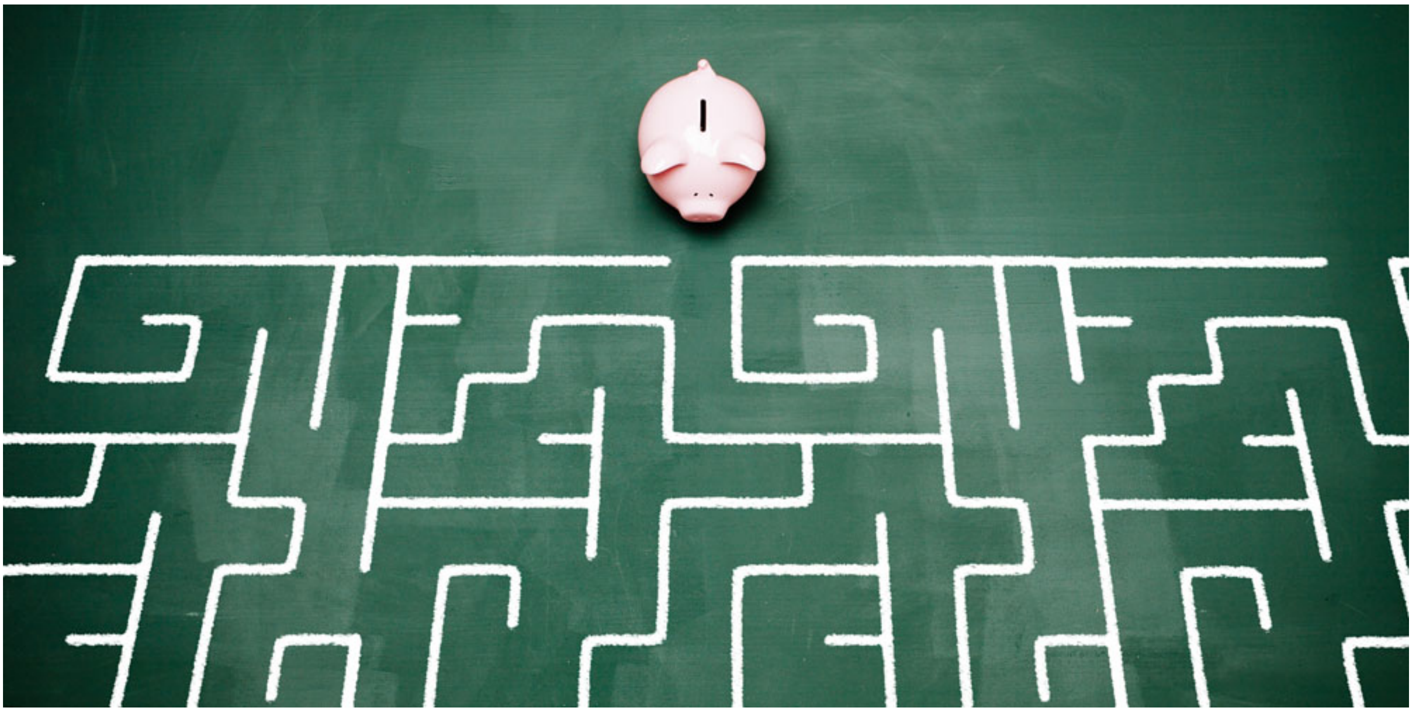

5% Bond Yields—How We'll Act

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With the possibility of 5% bond yields looming in the United States, what would provoke us into either buying or selling U.S. Treasuries?

Getting to 5%

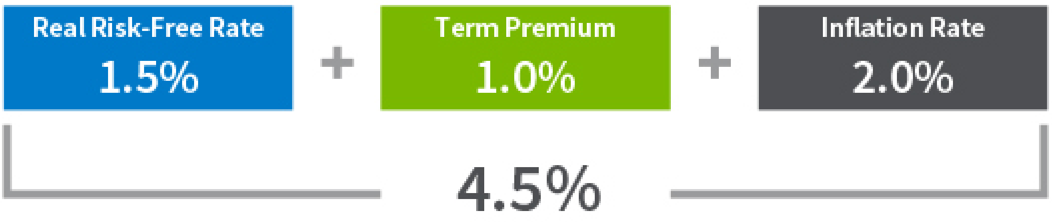
First, let's examine why we're closing in on 5% bond yields—by simply adding the components of bond yield.

The first component is the real risk-free rate, which is the theoretical rate of return of an investment with zero risk. It has averaged about 1.5% over the last century.

The second component is the term premium, the amount by which the yield-to-maturity of a long-term bond exceeds that of a short-term bond. For the 10-year U.S. Treasury note, it's about 1%.

The third component is the inflation rate, which is about 2% based on the U.S. Federal Reserve's target.

Add those together and you get 4.5%. And that's what I think the equilibrium state of affairs is as long as we're shooting for a 2% U.S. inflation rate.



Central-Bank Intervention

We believe central banks will intervene and support risky asset prices if they begin to decline. They intervened after the global financial crisis, pushing away investors from riskless and low-risk assets to higher-risk assets such as equities. In doing so, they brought the term structure down—in the case of Japan and Europe essentially to zero or a bit below.

The only alternative when interest rates are so depressed is to do what investors have always done—come up with new ideas to get yield, such as selling volatility and investing in alternative assets such as private equity and infrastructure, which given the numerous studies and reports that have been published over the past few years, I see as potentially problematic in terms of a bubble forming—defined in this case as too many investors chasing too few (quality) investment opportunities.

But central banks' ability to raise interest rates is limited by the market's response to those increases in rates. The Fed can only succeed to the extent that the market doesn't ultimately respond negatively as it did with during the Taper Tantrum.

That means rates are likely to rise slower than the market generally expects and, if that is the case, investors who are long the U.S. fixed-income market are unlikely to experience a sudden large capital loss as they did during the summer of 2013.

How We'll Act

Are we going to short the fixed-income market? In brief, not to any great extent.

To do so, we would have to have a view that is different from what's already priced into the market. We may be better off simply rolling shorter-term instruments—such as the 1-year U.S. Treasury—over time, capturing the slow-rising rates by bringing up the income portion of the portfolio.

The exception would be if we see a significant indication of change in Fed policy. Current Fed Chairman Jerome Powell is more willing to take downside in risky assets than former chairs Janet Yellen, Ben Bernanke, and Alan Greenspan, and that is one thing that gives us cause for concern—so we'll be monitoring the situation to determine our appropriate fixed-income positioning.

Brian Singer, CFA, partner, is a portfolio manager on and head of William Blair's Dynamic Allocation Strategies team.

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