strathbridge
ASSET MANAGEMENT

"By the Way"

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Vice President

Several consensus forecasts, that were taken for granted, have recently been tested. The U.S. dollar has weakened against its major trading partners, bond prices have fallen as interest rates have increased, the U.S. economy has stagnated while that of the European Union has shown signs of strength, and the price of oil has improved. Whether these are longer term changes in direction or mere blips in the prevailing trend remains to be seen, but it would be foolhardy to ignore their significance. We remain believers in the ongoing major trends; i.e. strong dollar, a U.S. economic rebound, and flat to down oil prices. However, we are spending more time listening to those with the opposite opinions rather than those who might just make us feel more comfortable.

Despite the volatility, global stock markets have continued to show strength. The S&P 500 has risen to an all-time high in the face of the weaker 1st quarter economic news; although the lack of strong follow-through since the breakout is cause for concern. The Fed remains "data dependent" before it will raise rates, and Europe, China and Japan continue to stimulate and provide support to equity markets.

As equity investors we enter dark waters when we express opinions on the direction of interest rates, yields and bond prices. The unkind among you might point out that yours truly suggested (exactly one year ago), U.S. treasuries were headed for a yield of 3%. I did add the proviso that a more normal fixed income market would be a requirement, and with central banks maintaining a zero interest rate policy, that has not been the case. Nevertheless, given the recent short term volatility in fixed income markets and the potential impact on stock prices, we must at least have a point of view on the direction of rates, if not the exact level. If we assume, as I do, that a world where regulated rates are near zero, and some sovereign bond yields are negative and this cannot last forever, we must come to the conclusion that rates are going higher. Unfortunately, even if this reasoning is accurate, it does not address the questions of when and how fast. But here is a hint; the German 10 year bond moved from a yield of less than 0.1% to over 0.6% in less than a month. Holders of a 30 year German Bund faced capital losses of 15% in that short time period. As I quoted in the last letter, things "happen faster than you thought they could".

"Failing to prepare is preparing to fail", said Ben Franklin. Fixed income investors should heed his advice and take a realistic look at their portfolios and the effect a rise in interest rates would have on asset values. The last bond bear market was over 30 years ago, so most people don't know what one looks like. If you own a bond directly and have the ability to hold it to maturity, there are only two risks: default and the interest not exceeding inflation. However, if one needs to sell prior to maturity, or owns a bond mutual fund or a fixed income exchange traded fund (ETF), liquidity becomes a major issue. "Liquidity" is not just a synonym for "marketable"; as Investopedia defines it: "The degree to which an asset can be bought or sold without affecting the asset's price." And there's the rub, if rates start to rise and prices fall, redemptions in these funds will force the managers to immediately sell the underlying securities and cause further weakness. Take look back at what happened to gold and silver and their ETF's when those commodities began to decline in 2011. I don't mean to suggest this will happen tomorrow, but it is a fact there is less "liquidity" in today's market, so I do recommend investors consider the possibility when reviewing their investment plan. So called investing "rules of thumb" have not had a great record in this seemingly different kind of market. But I offer this one to you: for every 1% rise in interest rates, the price of a bond or fund, in percentage terms, will decline by approximately its duration, (defined simply as the length of time to get your money back). For example, if the duration is 10 years, a 1% rise in rates will cause your investment to decline by 10%.

It is not my mission in these commentaries to promote the sale of Strathbridge funds, but I will anyway this time. In the current volatile fixed income environment, as an alternative, they could play an important role for those investors seeking a return from capital gains and dividends, but with an options program that would mitigate loss and provide increased yield in less bullish markets.

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