



INVESTMENT UPDATE

As we learned in Economics 101, "It all comes down to supply and demand." In our world, especially over the long run, the supply of—and demand for—bonds has a powerful effect on the level of interest rates, and therefore, bond prices.

Yes, this is an oversimplification. Supply and demand isn't all that matters, but many of the activities that impact prices do so through the supply/demand equation. As an example, consider the Federal Reserve's quantitative easing (QE) programs, particularly the large asset purchase plan, where the Fed has been buying billions of Treasury and mortgage bonds each month. This program was designed to lower interest rates, and it almost certainly has done so. How did it reduce interest rates? When the Fed purchased these bonds, the effect was to take billions of dollars worth of Treasuries out of circulation, reducing the supply of bonds

available to investors.

Without a commensurate decrease in demand, restricting the supply of bonds made them more scarce, pushing their prices up and their yields lower.

Likewise, it is common knowledge that interest rates are positively correlated with the business cycle, rising when the economy is growing and falling when the economy slows, seemingly unrelated to supply and demand. But when we consider that it's the changing demand for borrowed money—say, to buy a house, or to build a new factory—that rises and falls along with the general economy, we can see how interest rates are directly impacted once again by the demand for borrowed funds. This certainly helps to explain why interest rates have remained at historically low levels for years following the financial crisis: there just hasn't been sufficient demand for credit on the part of borrowers to drive interest rates higher.

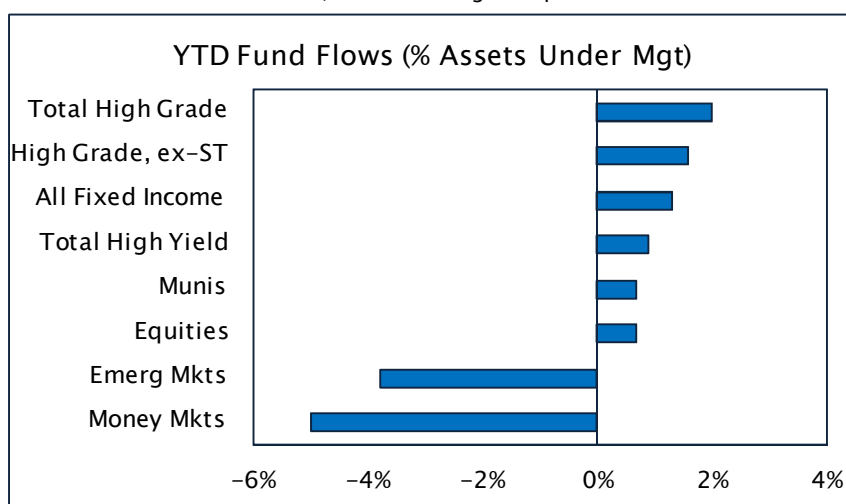
There have been two high profile instances of heavy supply coming into the capital markets over the past few days, with

different results. First was the large debt issuance from Apple on April 29th, which totaled \$12 billion—the sixth largest bond transaction on record (Apple had previously floated the second-largest-ever bond deal, \$17 billion, exactly one year earlier). After announcing the new deal on April 23rd, outstanding Apple bonds did exactly what we would have expected: their prices fell and their yields rose. But then a funny thing happened—these same Apple bonds in the secondary market began to "tighten," that is, their prices began to rise relative to benchmark Treasuries of the same maturity, leading to a narrowing of the yield spread between Apple bonds and their Treasury benchmarks. By the time the new deal had been priced and the new bonds had all been placed and were "free to trade," the existing Apple bonds were trading at the same or tighter spreads to Treasuries than where they were trading

before the new deal was announced. In other words, prices went up when the supply increased, in apparent violation of a cardinal rule of economics.

In the second recent case of flooding supply of securities, we saw a far more orthodox outcome. As you may

know, Twitter had an IPO of their common stock in November of last year, offering their shares to the public for the first time at a price of \$26 per share. By the end of the first day of trading, the shares had soared to \$45, giving the company an eye-popping market value of \$24.5 billion. The euphoria continued for a couple of weeks, with the stock price peaking in December at more than \$73 per share, before drifting back to the low-40s in late April. But on May 6th, the six-month "lockup" expired for insiders and early buyers—a provision that prevented selling by certain privileged investors—and that allowed millions of shares to flood back into the capital markets. Within three days, Twitter stock had fallen to \$30 per share, a drop of more than 20% and the lowest price since the IPO.



In fairness, these are two very different scenarios, and two different companies. For one, Twitter's stock price, like so many Internet-related companies, is nearly impossible to value; there is an element of faith—faith that revenue sources will pan out, subscribers will continue to grow, and that competitors will not put pressure on Twitter's future profitability. To make matters worse, Twitter has been revising some of their more optimistic forecasts for the business since the IPO, and while revenues continue to show excellent growth, Twitter has yet to post a quarterly profit. Meanwhile Apple is a product and financial juggernaut, and just beat their earnings estimates for the first quarter while socking away a few billion more in their huge cash hoard (which begs the question why they'd want to issue \$12 billion more in debt). Apple is one of the highest-rated corporations in the world today, with Moody's rating them Aa1 and S&P AA+.

The stunning performance of Apple's bonds led one Wall Street research report to declare, "Apple Bonds are Giffen Goods," referring to the rarely-seen economic phenomenon where a rising price leads to an increase in demand for that good. While we'd hesitate to classify them as such (Giffen goods are a kind of unicorn of the economic world), there's something weird going on in our market that we are struggling to understand. And it's not limited to Apple bonds; new issue supply for high-grade corporate bonds in the first four months of the year has been the heaviest in at least 15 years, and yet, yield spreads for corporates have been steadily tightening. Meanwhile, yields for longer-maturity Treasury bonds have been falling over recent weeks, despite evidence that the economy is beginning to pick up momentum after the weather-related slowdown of a very rough winter over much of the US. Year-to-date, yields on 30-year Treasuries have fallen 60 basis points (0.60%), 10-year bonds are 50 basis points lower, and 5-year Treasuries are 18 basis points lower.

So, to reiterate, the supply of new bonds is heavy, the Fed is backing away from their buying program, the economy appears to be getting back on track—and yet, rates and yield spreads are narrowing? Just what is going on?

The answer might be straightforward. It could just be that demand, the other side of the equation, has been even stronger than the increase in supply. Flow of funds data is available for our market, and that analysis shows that money has been pretty consistently allocated towards fixed income in recent weeks. According to Morningstar (which tracks only mutual funds, but is a useful proxy for the retail US markets), after suffering significant outflows in 2013, taxable bond funds saw inflows of

\$38.6 billion in the first four months of the year. To put this in context, Merrill Lynch estimates that net supply of high grade bonds in all of 2013 was \$254 billion. But this is only part of the picture, as these measures do not include the purchases of bonds from most larger institutional investors (including hedge funds) or commercial banks, nor do they include bonds that might be purchased by foreign central banks and sovereign wealth funds. The US Treasury tracks buying by non-US entities, and their data shows that foreigners increased their holdings of US bonds, on net, by more than \$100 billion in the first quarter, all of it coming in February and March. In all these cases, on net, the purchases are for longer-term bonds, as money has been flowing out of short-term and money market funds. By all accounts, there have been some heavy money flows into the US bond market over the past few weeks.

Unfortunately, we don't know the answer to "why"—why, against the backdrop of the tapering of the Fed's buying programs and an economy that's bounced off the floor and is giving off a sniff of future inflation—why are people buying longer-maturity bonds? True, the economy's not growing near its potential, and neither are China, Japan or the Eurozone, but that's hardly news. There may be trouble brewing in Ukraine, and the Middle East continues to be a roiling cauldron of unrest, and while that could lead to a general flight to quality, it wouldn't follow that it would also lead to buying of longer-dated Treasuries instead of ultra-safe short-term bonds. One of the more compelling explanations is that corporate pension funds, boosted by strong performance from the equity markets and approaching "fully funded" status, are adopting European-styled liability-driven investment strategies, and buying long bonds to match their long-term pension obligations. Unfortunately, there's no way to accurately gauge to what extent this may be happening.

Clearly, 10-year Treasury yields hovering at 2.5% is low by almost any historical measure, and well below what we would expect five years into an economic recovery. Yet the simple fact of the matter is that the US economy (not to mention the global economy) is not growing like it did in decades past. Even the Fed's own forecasts have, over recent quarters, shown a consistently overly-optimistic outlook for US growth and an overly dim view of the future rate of inflation. And while we're not rushing out to buy Treasuries at these levels, we have to acknowledge that these yields reflect the reality of the slow-growth, low inflation world that we live in, a world that may be here to stay for an extended period.

Could it be that the demand for bonds at these prices makes sense, and that the markets aren't so crazy after all?