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Is the End of the Bond Bull Market Finally Here?

For about 35 years, investors have enjoyed a bull market in bonds. At the start of 1982, the interest rate on 10-year U.S. Treasury bonds was 14.2 percent. By November 1, 2016, interest rates had fallen to 1.8 percent.[1] Since bond prices increase as interest rates fall, U.S. Treasuries (and other types of bonds) have rewarded many investors with attractive total returns during the past few decades.

In the natural course of events, bull markets end and bear markets begin. About six years ago, experts began to caution the bull market would end, interest rates would begin to move higher, and a bear market in bonds would ensue.[2]

Bond guru Bill Gross was one of the first to sound an alarm in his July 2010 commentary.[2] The Federal Reserve's first round of quantitative easing (QE) – purchasing billions of dollars of mortgage and Treasury bonds – had ended in March 2010, and Gross didn't yet know the Fed would initiate a second round of QE in November of that year. The action helped keep interest rates low.[3] *The Economist* explained the effect of quantitative easing:[4]

> "Like lowering interest rates, QE is supposed to stimulate the economy by encouraging banks to make more loans. The idea is that banks take the new money and buy assets to replace the ones they have sold to the central bank. That raises stock prices and lowers interest rates, which, in turn, boosts investment. Today, interest rates on everything from government bonds to mortgages to corporate debt are probably lower than they would have been without QE."

As U.S. economic growth strengthened, predictions of rising interest rates resumed. During 2012, *The Wharton School's* online business journal published an article titled, "*The End of the 30-year Bond Bull Market*?" It predicted rates would soon move higher:[5]

> "While many people think of bonds as conservative holdings, they have produced stellar returns for decades, thanks to the taming of inflation and other factors…But many experts say economic recovery could now reverse the process by driving interest rates higher, causing bond prices to fall. Yield on the 10-year U.S. Treasury rose to around 2.25 percent in March, after hovering around 2 percent for four months."

Low inflation, sluggish economic growth in the United States and abroad, and geopolitical shocks, such as the European debt crisis, continued to support investors' appetite for bonds and the bull market persisted. It wasn't until late 2013 the Federal Reserve decided the U.S. economy was strong enough to benefit from less easy monetary policy.[6]

The Fed began to taper its QE program in January 2014[6] and ended the program in October of the same year.[7] In December 2015, the Fed raised the fed funds rate for the first time in almost a decade.[8] Treasury yields rose immediately, following the increase, then moved lower as,[9]

> "…the markets succumbed to fears of recession and concluded that the Fed had made a serious error of judgment," reported *Financial Times*. "Fewer money professionals now find fault with the Fed's decision to start raising rates back then. The next big question is whether the great 35-year bond bull market is finally over."

Financial Times is not alone in speculating about the future of the bond market. There are sound reasons to believe interest rates may be headed higher. For instance:

- The Federal Reserve is expected to raise rates before the end of 2016. A September 2016 Reuter's poll found the majority of participating economists expect the fed funds target rate to increase during the fourth quarter. Seventy percent believe the increase will happen in December.[10]

- U.S. inflation appears to be moving higher. *The Wall Street Journal* reported, during the third quarter of 2016, the Fed's referred measure of inflation – core inflation excluding food and energy – reached a two-year high. A tightening labor market, higher wages, and rising oil prices could also help push inflation higher.[11]

- Europe's economy is showing improvement. *Focus-Economics* wrote, "The Eurozone's economy continues to exhibit resilience, suggesting that some concerns of an immediate Brexit-induced shock to growth were overblown... Moreover, the Eurozone's growth story remains broadly unchanged as low inflation, ultra-loose monetary policy, and a recovering labor market continue to act as tailwinds to the domestic economy. Adding to the positive news for the common-currency bloc, a number of near-term political risks seem to have abated in recent weeks."[12]

- Central banks may be near an inflection point. Some experts believe global central banks, including the Bank of Japan, Bank of England, and European Central Bank, may be considering less aggressive monetary policies, which could support higher interest rates.[13]

During October 2016, bond rates moved higher in Europe and the United States. Yields on 10-year German Bunds, which were offering negative rates (-0.2 percent) in the summer of 2016,

rose to 0.172 percent early in November 2016.[14] U.S. Treasury yields moved higher in late October 2016 and then fell as investors grew wary about the outcome of U.S. elections.[15]

It's too soon to know whether the bond bull market is at an end, but years of speculation – and recent fluctuation in bond values – highlight the importance of having a well-diversified portfolio that is targeted toward your financial objectives. If you're not sure how to prepare your portfolio for a bear market in bonds, talk with your financial professional.

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