EXECUTIVE SUMMARY

After years of market anticipation the Federal Reserve finally raised the target Fed funds rate to 0.25%-0.50%, completely devastating bond investors prompting markets to breathe a sigh of relief that it had finally come to pass. Following the hike—a first step on a path toward normalization—the Fed’s statement assured investors that despite promising economic and inflation data in the U.S. there are headwinds abroad (as reflected in softer net export results). Therefore, we are likely to see “only gradual increases” ahead. For those of us who expected the first rate hike in September, it’s better late than never.

Generally speaking, Q4 2015 was a poor quarter for bonds, since yields tended to rise across sectors (save for munis). But we've seen a rocky start for equities in the New Year (thanks, China!), which may portend a good chance for bond investors to make up lost ground.

We Have Lift Off!

- Lipper’s General U.S. Treasury Funds classification sank 1.48% for Q4 2015 as yields rose in anticipation of a Fed rate hike.
- Corporate debt fund classifications were generally lower, with High Yield Funds cratering 1.90% and Loan Participation Funds down 2.09%.
- The largest fixed income group, the $686-billion Core Bond Funds group, ended Q4 with a loss of 0.59%.
- Munis decoupled from Treasuries; the average single-state muni debt fund was up 1.36% for the quarter.

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As seen in Figure 1 below, Lipper’s General U.S. Treasury Funds classification was among the quarter’s worst performers, losing 1.48% as yields on the ten-year note rose from 2.05% at the end of September to 2.27% at the end of December. As the clock was ticking on the Fed’s decision, Fed futures markets raised the probability of a hike to about 74% by the end of November—the most optimistic it had been in a long time. The beginning of January saw just a 10% probability that 2016 would pass without another rate hike. In other words the market widely believes we’ll see another hike in 2016. Short U.S. Treasury Funds lost 46 basis points (bps) for the quarter but managed to finish the year up 25 bps. TIPS Funds lost more ground in Q4 (-0.62%) on the way to a disastrous negative 2.45% return for the year as low energy prices dashed any thoughts of unexpected inflation ahead.
TREASURY FUNDS SUMMARY
As shown in the chart below (Figure 2) the yield curve rose perceptibly in the belly of the curve and just slightly at the long and short ends, flattening the curve. The two-/ten-year spread narrowed from 1.41% to 1.21%, still trending downward from the post-recession high of 2.83% for 2010 and a long way from a pre-recession inversion. Yields on the two-year note touched as low as 0.57% in mid-October but generally trended up throughout the quarter to end at 1.06%. Ten-year notes trended similarly, starting at 2.05%, dipping briefly to 1.99%, then going relentlessly higher to 2.27% at year-end.

FIGURE 2 TREASURY YIELD CURVE

Historical Yield Curve

Source: U.S. Department of the Treasury
CORPORATE AND MORTGAGE-BACKED BOND FUNDS SUMMARY

Although higher-rated credits outperformed lower, it would be a stretch to describe the quarter’s performance as a flight to safety. In fact, all three credit-specific corporate bond fund groups lost ground for the quarter as investors grew anxious about junk bond contagion within commodity-related sectors. That said, issuance for 2015 was at record levels by the end of November (about $1.28 trillion) because of record amounts of M&A activity—some of that due surely to leveraging up before interest rates presumably head higher in 2016.

Corporate debt yields rose over the quarter, while option-adjusted spreads on the Bank of America Merrill Lynch US Corporate BBB index remained fairly tight and even dropped from 240 bps at the start of the quarter to 219 bps at the beginning of November; over the remainder of the quarter spreads trended back to 240 bps. The net effect was that Lipper’s Corporate Debt BBB-Rated Funds classification lost 1.00% for December during the widening to end Q4 down 0.75%. Corporate Debt A-Rated Funds wasn’t much better, losing 0.67% for the quarter, while High Yield Funds (which saw junk bond spreads punch through the 700-bp mark for a few days in December) lost 2.30% for December and 1.90% for Q4.

Nearly bucking the bond market trend, mortgage paper was up ever so slightly for December; GNMA Funds drew a zero for the month to end the quarter down 14 bps, and the U.S. Mortgage Funds classification lost 20 bps for December to end Q4 down 42 bps. According to Trepp, the delinquency rate on commercial mortgage-backed securities rose to 5.17% in December, ending a three-month streak of improvements, but it was still lower over the full year.

WORLD INCOME FUNDS SUMMARY

The trade-weighted U.S. dollar index rose in Q4 from 120.93 to 122.83. Higher interest rates in the U.S. and sluggish growth elsewhere served to make the greenback more attractive, and more ructions in China will likely keep adding fuel. Alternative Currency Strategies Funds suffered a loss for December of 1.09% and a quarterly loss of 0.28%, leaving that group down 5.08% for the year. International Income Funds handed investors a 0.36% quarterly loss. Emerging Markets Hard Currency Debt Funds lost 2.19% for December yet somehow managed to salvage something out of October’s nice return to engineer a 0.68% quarterly return; the Local Currency Funds classification lost just 5 bps for Q4, but we can’t ignore that minus 13.49% return for all of 2015.

MUNICIPAL DEBT FUNDS SUMMARY

Muni investors refused to be drawn into the Treasury morass as they flocked to their favorite target and were well compensated for it; the average single-state muni debt fund returned 1.36% for Q4 and a respectable 2.62% for 2015 (all figures pre-tax). Lower energy prices helped several muni sectors, such as toll roads and airports, and supportive data on state tax receipts helped even more (Moody’s 2016 Outlook was stable-to-positive for the largest public finance sectors). Headline risk out of Puerto Rico remained a concern, despite fewer mutual funds willing to hold PR paper anymore. For 2015 the S&P Muni Bond Puerto Rico Index was down over 8.0%.