

View
from the

Bond Desk

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Foreign Investing in U.S. Bond Markets

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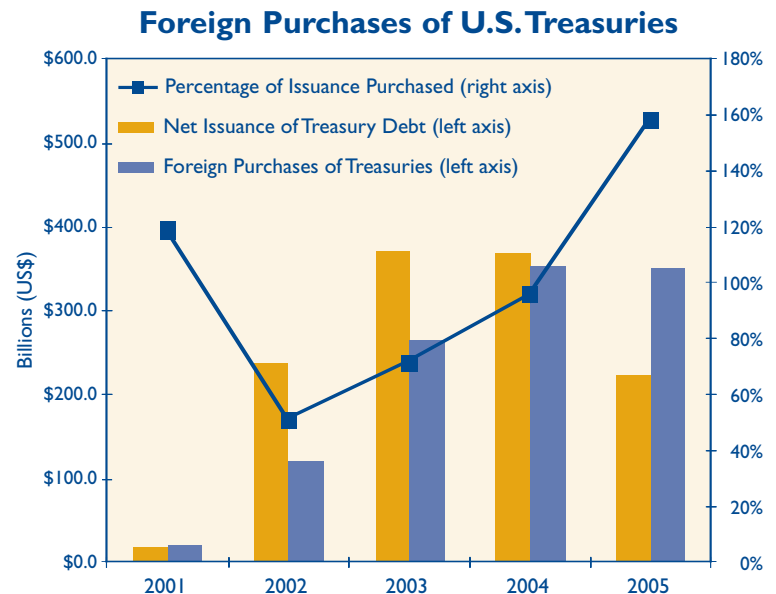
The fourth quarter 1.6% GDP growth is now a distant memory. The weaker than expected growth can be attributed to just a few items: an auto related slowdown in retail sales, a surge in imports, surprisingly anemic business spending, and a very surprising drop in national defense spending. One data point does not make a trend. The data since the GDP release have been quite strong: retail spending accelerated sharply in January; exports have increased even more than imports; business spending is moving higher; and government spending is, well, government spending – there does not seem to be a dearth of it, especially national defense spending.

On top of these stronger economic data, the Federal Open Market Committee remarked in the minutes of their January 31, 2006 meeting that inflation expectations and core inflation readings have been higher than are desirable. The latest Beige Book of economic conditions asserts the same thing. The prospects for lower inflation seem dim in the context of \$60 oil, a 4.8% unemployment rate, and 80.9% (and moving higher) capacity utilization rate.

I believe the outlook for U.S. yields is still dependent upon the foreign capital flows. The

\$1 trillion worth of bonds that foreign investors purchased in 2005 (the actual number is \$969 billion) goes a long way toward explaining the low yields currently available, as well as the flatness of the yield curve. Foreign investors purchased an amazing 158% of the net new issuance of Treasuries in 2005 (on top of 95% in 2004), and they have also purchased a huge percentage of the net issuance of agency and corporate bonds. In fact, foreign investors purchased an astonishing 55% of ALL debt issued in the U.S. last year (and 60% in 2004). ALL means all Treasury, Agency, Mortgage, Corporate, Asset-Backed Security, Money Market Security, and Municipal Bond issuance – \$1.76 trillion. Those that are predicting low yields at the long end of the yield curve into the future had better hope that this buying pattern continues or that the U.S. economy falters fairly soon. If the purchasers of \$1 trillion of our debt stay on the sidelines, the price of bonds will have to falter and yields rise.

It seems dubious to assume that the U.S. economy is headed toward a recession. So long as the jobs growth continues, I believe the economy will grow. As for foreign central bank inflows, they are dependent upon the desire to keep cur-



Source: U.S. Treasury Department. Treasuries are negotiable debt obligations of the U.S. government backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal taxes.

rencies from rising versus the dollar. Private foreign inflows are dependent upon a lack of significant investment opportunities away from the U.S. With the uptick in global growth currently under way, it is possible that the private foreign investors may find other opportunities to invest their monies and those foreign central banks may not feel the need to suppress their currencies' strength versus the U.S. dollar quite so vigorously.

It is practically impossible to predict accurately what the future of the bond market holds. However, it does seem that the risks to the long end

of the yield curve outweigh the rewards at this point. Whether foreign investors are buying or not, whether the Fed is done raising rates or not, an investor should always have a portion of their portfolio in fixed income. But you can help protect your investments. We have more bonds maturing at the front end of the ladder (shorter maturities) than at the back (longer maturities). We just feel one is not rewarded for the longer maturities. Having bonds mature over the next few years should provide some opportunities to increase the yields without depressing the market value so radically. ■