THE Weekly View
RIVERFRONT INVESTMENT GROUP
Asset Management • Investment Strategy • Advice

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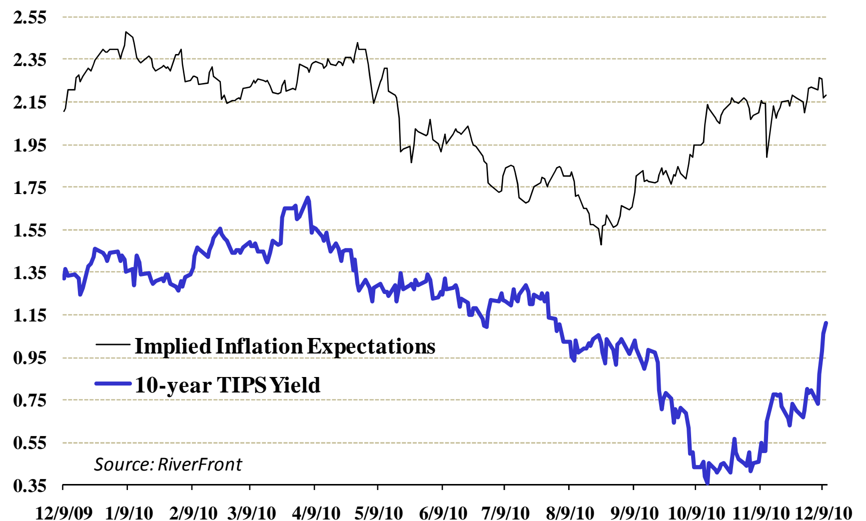
Bond Yield Backup Positive For Now

- A one percentage point rise in bond yields over the last month and a half (to 3.3% from 2.3% on the 10-year Treasury) reflects rising growth and inflation expectations, which have been viewed positively by the stock market. This has been prompted by recent better economic news, from global purchasing manager surveys to the downtrend in initial jobless claims, and the somewhat surprising compromise deal to extend tax cuts and unemployment benefits in what amounts to a 'second stimulus.' This stimulus adds about $300 billion to the deficit in 2011. In the short term, we believe fears of increased government debt from the compromise are subordinate to the anticipated pickup in GDP growth of as much as one percentage point (which would help reduce the unemployment rate by a few tenths of a percentage point). Indeed, growth expectations have risen significantly judging by the 10-year TIPS yield, which ended last week at 1.11%, up from 0.36% in mid-October (see chart below). Meanwhile, inflation expectations have risen more modestly — a stated goal of the Federal Reserve — to 2.2% annualized from 1.9% over the same time period (as measured by the spread between nominal 10-year Treasury yields and the TIPS yield — Implied Inflation Expectations in the chart). As long as higher yields are primarily driven by rising growth expectations (real yields), we do not see them as an impediment to further stock gains. In fact, higher growth implies a greater ability to service debt. Although we still think that long-term structural deficits need to be reduced in order to lower a threatening debt overhang, a faster economic expansion would help make the adjustment easier.



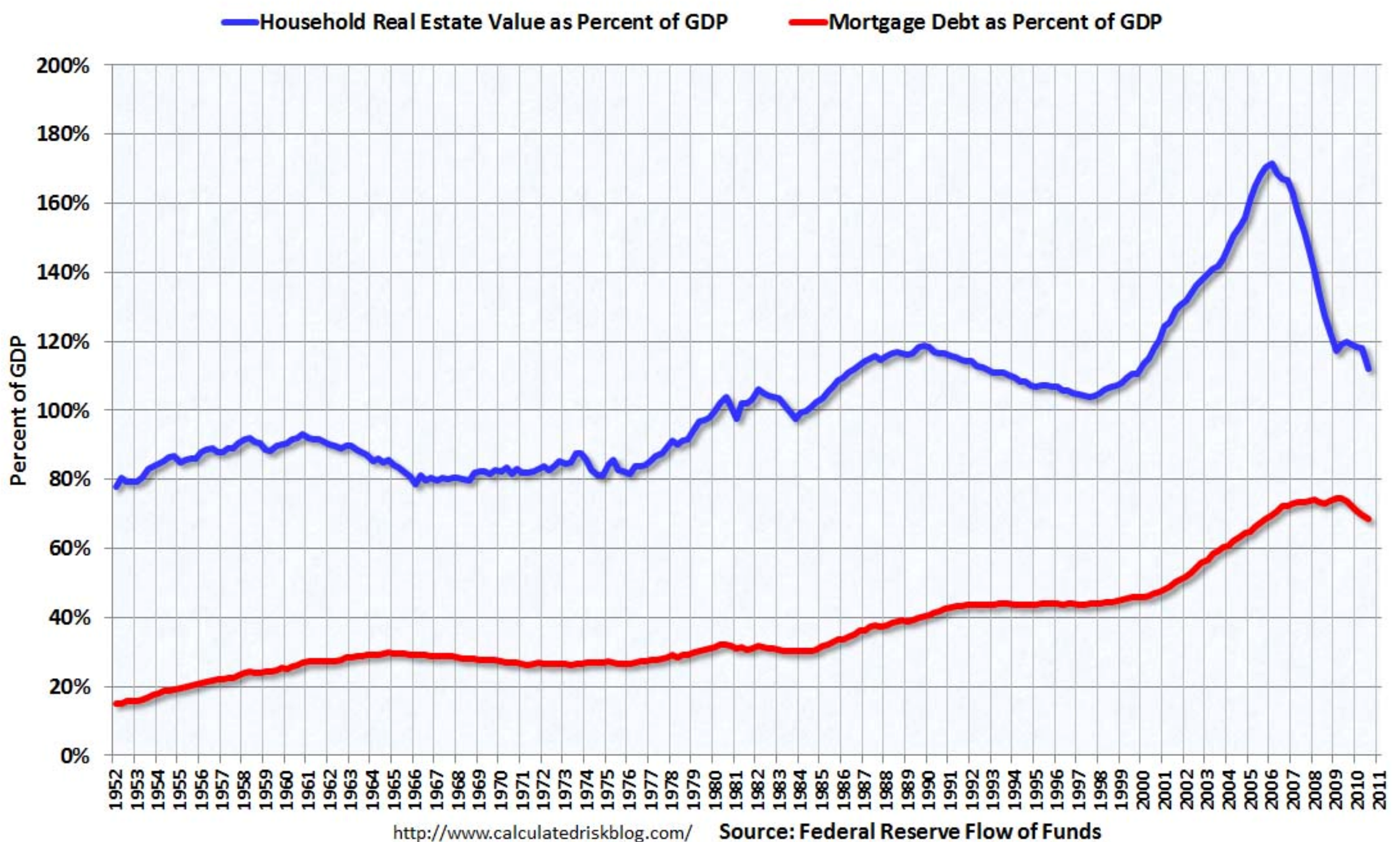
- Ultimately, we think there are limits to how much interest rates can rise, even if driven by rising growth. This is mainly because of the still-fragile housing market, which adjusts to higher mortgage costs to some degree through price declines, especially given still-high housing inventories. In turn, secondary impacts from higher interest rates on consumer confidence and household spending have the potential to overwhelm recent economic progress. About a year and half ago, we stated that we would be comfortable if conventional 30-year fixed mortgage rates stayed below 6.5%. But given the extraordinary degree to which rates have fallen since then, our threshold of worry is now around 5.5% to 6%, which implies 10-year Treasury Yields of 4% to 4.5%. Currently, with 3.3% 10-year Treasury yields, 30-year fixed mortgage rates are about 4.8%, up from the recent record low of 4.2%.

- Rising rates over the near term may be somewhat self-fulfilling. Longer term Treasuries are widely perceived as overvalued — RiverFront has avoided them for more than a year — but have 'worked' partly because investors have been chasing returns in what *was* one of the best performing asset classes this year. As it increasingly looks like European woes and Chinese tightening won't cause a major global retrenchment next year, investment flows have been moving out of bonds and into stocks in recent weeks, with rates and prices moving

accordingly. We expect this to continue into 2011 until the effects of rising rates, as 10-year Treasury yields move toward 4%, start to weigh on this process.

- Household net worth rose $1.2 trillion in the third quarter according to the Federal Reserve's Flow of Funds Accounts report. Household financial assets (led by stocks gains) increased about $1.9 trillion, but household real estate subtracted roughly $700 billion (as home prices resumed their decline). Meanwhile, mortgage debt fell by 'only' $65 billion, primarily through defaults. Household mortgages of just over $10 trillion still remain high, at about 70% of GDP (historically this has been less than 50%), which suggests several more years of deleveraging at the current pace (see chart below). Rising stock prices should help cushion the blow, indeed more than offsetting home price declines last quarter, but only to the extent of the overlap between any particular household's financial and real estate assets. At the margin, we suspect that wealthier households have a much higher percentage of their assets in stocks (and bonds) than lower-income households. Hence, even though household net worth may be rising in aggregate, it is likely masking disparities along the income spectrum. Notably, the wealth effect and the propensity to consume are likely to be lower than if home price gains were leading aggregate household net worth higher.

The Weekly Chart: Less home equity to support mortgage debt



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