

Are We in a Bond Bubble?

Investors have been pouring money into bonds. Investment Company Institute statistics show that since January 2007, average net new money going into bond mutual funds each month has been roughly four times greater than net *outflows* from equity funds. * So does that mean we're in the bond market's equivalent of the late-1990s tech bubble?

What's been driving interest in bonds?

There are several reasons why bond funds have been attracting investor interest. First, in the wake of both the tech crash of 2000-2002 and the 2008 financial crisis, the Federal Reserve felt it needed to make credit more available by lowering interest rates. Over the last 10 years, the yield on the 10-year Treasury bond has fallen from 5% to well under 3% at the end of 2010.** And for the first time ever, 5-year Treasury Inflation-Protected Securities (TIPS) actually paid a negative yield when they were auctioned last October.*** Because bond prices rise as interest rates fall, that has increased bond prices generally.

As a result, bonds have outperformed stocks in recent years. For the last 20-year period, total returns from stocks and bonds have been equal: 8.2%.**** And during the decade between January 2000 and the end of 2009, bonds actually outperformed stocks; the S&P 500 saw a total return of -0.9%, while long-term government bonds returned 7.7%.**** That outperformance has lured investors who may have forgotten that past performance doesn't guarantee future results, and invest in an asset class based on its recent history rather than its prospects for the future.

Demographics also have played a role. Many aging baby boomers who became accustomed to investing much of their IRAs and 401(k)s in stocks are beginning to realize that their time horizon for retirement isn't as long as it used to be, and that they should consider allocating an increasing percentage of their retirement portfolios to income-producing assets. The financial crisis also sent many frightened investors scurrying to put their money anywhere besides stocks.

Finally, diminished dividends from stocks have encouraged many investors to look elsewhere for income. During the tech boom, companies preferred to reinvest in growth or buy back stock rather than increase dividends, and according to Standard and Poor's, 2009 was the worst year on record for dividend payments. Though there has been some reversal of that trend in recent months, stingy dividends helped make bonds and their income more attractive.

What to watch out for

No investing trend lasts forever without interruption. Here are some factors that could affect bond prices:

Signs that inflation is picking up: Higher inflation means fixed income payments will have less purchasing power in the future, diminishing bonds' appeal as income vehicles.

Fed reversal on interest rates: As the economy recovers, the Federal Reserve will need to withdraw the support it has given the bond markets. As it gradually ratchets up interest rates, bonds will begin to reverse their pattern of the last decade. Depending on the pace of the Fed action, that reversal could be swift. Rising interest rates typically mean falling bond prices, and longer-term bonds often feel the most impact because bond buyers are reluctant to tie up their money long-term if a better rate lies ahead.

Lack of overseas interest in U.S. debt: Foreign buyers have been large purchasers of U.S. government debt. If foreign buyers show signs of turning away from U.S. debt, it could send shivers through the bond markets.

Muni bond troubles: Some experts worry that defaults by cash-strapped state and local governments could become a problem.

However, balance those factors against the possibility of further sovereign debt problems abroad. Several European nations are still struggling to deal with their debt problems; another bout of global jitters like the one in spring 2009 could remind investors that the United States has never defaulted on its debt. Also, if the potential for deflation that the Fed is so concerned about turns into an actual decline in wages and prices, that could be a positive for bonds, since the income they pay would be more valuable as prices fall. Either way, now is an especially good time to keep an eye on your bond investments.

*Average of monthly net new cash flows from January 2007 through September 2010 as reported in Investment Company Institute's "Long-Term Mutual Fund Flows Historical Data" as of Nov. 20, 2010.

**Source: U.S. Treasury historical data on daily Treasury yield curve rates.

***Source: "Record Setting Auction Data," www.treasurydirect.gov.

****10- and 20-year returns based on data on the Standard and Poor's 500 and long-term government bonds from *Ibbotson SBI 2010*.

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