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STOCK MARKET QUARTERLY REVIEW


Bonds Prove a Winning Bet,
Even as the Fed Raises Rates

By AARON LUCCHETTI
Staff Reporter of THE WALL STREET
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To find a quarter like this past one in the bond market, turn the calendar back to 1971.

Treasury-bond prices rose during the past three months, pushing yields lower. That happens a lot. But what made the latest quarter unusual was that bond yields were falling even while the Federal Reserve was continuing to raise its target short-term interest rate.

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THE JOURNAL REPORT

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The market action in bonds "seemed truly bizarre" in the third quarter, says Jeffrey Gundlach, co-manager of TCW Galileo Total Return Bond Fund, who notes that it has been 33 years since yields have fallen so much when the Fed was beginning to raise short-term rates. In late summer 1971, short-term rates moved up while long-term bonds yields fell. That didn't last long, as short-term rates

paused and then declined for the rest of the year.

Indeed, the bond market rallied early and often during the latest quarter. Newfound demand for Treasury bonds and notes bumped prices up, causing the yield on the 10-year note to fall below 4% for the first time since early April, as yields and prices move inversely. (Bonds continue to trade in the secondary market after being issued, and yields change to reflect the price and the securities' fixed interest rate.) At the end of the quarter, the 10-year Treasury note's yield stood at 4.125%.

The Fed's rate-setting committee increased its target short-term federal-funds interest rate twice during the quarter, to 1.75%.

During the quarter, the benchmark 10-year Treasury note boasted a total return of 5.23%, according to money manager and research firm Ryan Labs. That return -- based on the bond's price and its interest rate -- made the past three months the best quarter for Treasuries since the third quarter of 2002, when the 10-year note returned a red-hot 11.7%.

Behind the bond rally was a growing belief that the U.S. economy faced too many headwinds to expand very quickly. Investors shifted money from stocks and from cash with a renewed comfort that yields on long-term debt wouldn't shoot up soon and that current issues would remain attractive.

HOW THEY FARED

See a rundown of the [major indexes](#).² Plus, browse a full rundown of statistics, including bond yields, money rates, and mortgage data, every day in the Wall Street Journal Online's [Markets Data Center](#).³

Bond yields tend to move up and down with the economy. Because employers find it harder to fill jobs when the economy speeds up, wage pressures rise, and inflation often follows. To stop inflation from rising out of control, the Fed typically raises its target short-term rates. Bond traders try to anticipate the moves, demanding a higher yield to hold securities with a fixed payment that won't increase with inflation, pushing down prices on existing issues.

But if investors become more skeptical about

the economy -- as they did last quarter -- they are more willing to buy bonds with lower yields. Already-issued bonds become more attractive and go up in price. The cycle of buying typically continues until stronger economic data change investors' minds and convince them that paying a higher price for a fixed return of, say, 4%, no longer is so smart.

The surprising third-quarter rally in bonds sets up this question for the rest of the year: Will the bond market finally stumble, sending yields higher? After all, many economists at the beginning of the year predicted yields would be higher this year, and in the past two years, they have occasionally risen sharply.

Two things need to happen first, says Robert Auwaerter, head of bond investments at mutual-fund firm Vanguard Group: "One is job growth" and the other is "finally getting oil prices down."

The steady rally in bond prices during the past three months highlighted a new relationship between bonds and oil. In the past, rising bond yields usually were associated with increases in crude-oil prices. Rising yields indicated a stronger economy, which typically would provoke greater demand for oil.

But in the past two years, oil prices have surged higher without much of a rise in the 10-year note's yield. At the end of 2002, the 10-year Treasury yield was around 4% and the price of oil was around \$31 a barrel. Since then, the price of oil has risen more than 50%, but bond yields have been on a roller-coaster ride to nowhere.

What has changed? A recent report from Bianco Research points out that many analysts believe the recent move in oil is being driven by supply and demand factors that don't necessarily lead to broader inflationary pressures. Oil and commodity prices in general are a smaller component in the U.S. economy than they used to be. Some economists also argue that oil-price increases today act as more of a consumer tax, curtailing spending, which actually has the opposite effect on bonds than broad inflation would.

Changes in oil prices don't spread into the rest of the economy like they used to, says Vanguard's Mr. Auwaerter. Improved technology and productivity have combined with interconnected global labor markets to keep the costs of goods and labor relatively low, even if commodity prices are rising.

In the third quarter, government bonds with longer maturities outperformed just about everything else. Through late September, Lehman Brothers indexes that track various parts of the bond market showed that Treasuries maturing in 20 years or more have had a total return of about 7% in 2004, three percentage points better than corporate bonds, and four or more percentage points ahead of U.S. government-agency bonds, bonds backed by fixed-rate mortgages and securities backed by consumer assets such as automobiles, known as asset-backed securities.










Lehman's overall Treasury index, which includes shorter maturities such as 10-year and five-year notes, has risen about 3% this year, roughly in line with intermediate-term corporate bonds and fixed-rate mortgage-backed securities.

Corporate bonds performed well in the third quarter, despite the fact that the economy showed signs of softness. The yield on investment-grade corporate bonds, for example, stayed in a stable range of about 0.8 to 1.0 percentage point more than comparable Treasury securities, a narrow margin reflecting limited concern about the credit-worthiness of U.S. corporate-bond issuers.

"We've been in a low volatility environment" for U.S. corporate bonds, says Will Hawley, a portfolio manager with Los Angeles money-management firm Payden & Rygel. "Corporate America has been on the mend. Leverage is decreasing, and cash flow is picking up."

With economic growth moderating and payroll additions still somewhat meek, corporations aren't expected to take on extra debt to do risky deals any time soon. Instead, they will continue to pay off the regular coupon payments on their bonds, Mr. Hawley says. "It's not a blow-away environment for credit, but it's a decent environment to clip coupons," he says.

Write to Aaron Lucchetti at aaron.lucchetti@wsj.com⁴

MARKET BOXSCORES: HOW THE MAJOR INDEXES PERFORMED				
	THIRD-QUARTER PERFORMANCE		CLOSE 9/30/04	CHG FROM 9/30/03
Dow Jones Industrial Average	-3.4%		10080.27	8.7%
DJ U.S. Total Market	-2.3		264.11	12.5
DJ World (excl. U.S.)	-0.2		150.10	20.0
Amex Composite	1.8		1271.83	28.4
NYSE Composite	-0.5		6570.25	16.4
S&P 500	-2.3		1114.58	11.9
Russell 2000	-3.1		572.94	17.5
Value Line (Geometric)	-4.7		359.10	12.7
Nasdaq Composite	-7.4		1896.84	6.2

Source: WSJ Market Data Group

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