Fixed Income Market Comments

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from Montage Investments

Market Volatility Can Provide Valuable Perspective on Long-Term Investment Strategy

The past two weeks have seen significant swings in asset prices across markets worldwide. While the first three quarters of 2014 were marked by relatively calm markets and historically low volatility, October has ushered in a much more volatile environment. The six days from October 9th through the 16th saw domestic equity markets sell off sharply and U.S. Treasury bonds rally strongly on record volume. A convergence of negative news helped drive the sell-off in risky assets: weak economic data from Europe; re-emerging concerns over Greece; plunging oil prices (which are seen as an indicator of worldwide economic slowdown); and the headline-grabbing Ebola cases in Spain and Texas.

Sell-offs in a number of risky asset classes reflected a "run for the door" reaction that accelerated downward moves as liquidity evaporated. The Dow Jones Industrial Average erased all of its 2014 year-to-date gains. High-yield bond yields rose to their highest level in over a year, increasing more than 1% since June, while leveraged loan prices dropped to the lowest levels since 2012. The rush to safety drove billions of dollars into "safe-haven" investments, pushing the yield on the 10-year Treasury below 2%, a 15-month low.

Since Oct. 16th U.S. stocks have rallied back strongly, leading some investors and strategists to write off the events of the past two weeks as a brief panic correction. While it was certainly short-lived, the broad and rapid movement across multiple markets make us wary that this may not be one-time occurrence, but instead a preview of how future changes in sentiment might manifest in markets, given the high asset valuation and low liquidity environment. The lack of market depth reportedly led to high-yield fund managers having to sell their more liquid investments (such as U.S. equities and/or higher quality bonds) in order to meet fund outflows. In a down market of greater duration, there could be a forced liquidation of more speculative securities, creating far larger losses for investors with exposure to the high yield and alternative fixed income sectors.

With market volatility returning, we believe investors would be well served to use these past few weeks as a reminder to review their long-term investment strategy. Over the past few years, stubbornly-low bond yields have prompted many investors to seek higher returns in junk bonds and fixed-income alternatives. As the markets reminded us last week, though, with higher yield comes greater risk. Now is a good time for investors to reconsider whether their exposure to riskier assets (especially in place of high-quality core fixed income) is appropriate for their risk tolerance, and thus their long-term asset allocation. In volatile markets, preservation of principal can be as, or more, important than trying to earn slightly higher returns.

At Ascent, we invest for the long term, with an eye on creating and maintaining a strong foundation of an investor's asset allocation. This steady approach means that the market moves of the past few weeks have not affected our investment approach, nor caused us to sell any holdings. We expect volatility through market cycles in general, and with valuations currently still high and liquidity low, we expect large price swings like those of the past few weeks may become more common as investor sentiment shifts. October has been a good reminder why investors' asset allocation and portfolio strategy should be managed with a long-term perspective, instead of built in a manner that can be hastily influenced by week-to-week moves in the markets, even sharp and dramatic ones.

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