Market View: What Would "Normal" Rates Mean for Bonds?

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With less Fed influence, interest rates could revert to their historical relationship with GDP.

During much of the past 30 years that interest rates have been declining, there have been repeated forecasts that the trend was due for a reversal. While those forecasts have been incorrect, there are mounting reasons to expect a *normalization* of interest rates going forward.

One of the most apparent reasons may emerge from the Federal Reserve—an entity that has had the largest influence across the capital markets over the past several years. Fed members previously mentioned that they have considered adjustments to its quantitative-easing initiatives, and in the minutes from the Fed's latest policy meeting, some members suggested making adjustments in the coming months or by the end of the year.

The Fed's influence on long-term interest rates has caused a significant dislocation between the historically close relationship between the real 10-year Treasury yield and the rate of economic growth. Indeed, the real yield (that is, the nominal yield minus inflation) on the 10-year Treasury note has averaged about 2.57% over the last 20 years—nearly identical to the average growth rate of gross domestic product (GDP) of 2.53% over the same time frame according to Bloomberg.

The Real 10-Year Treasury Yield Has Returned to Negative Territory

Source: Bloomberg; data from 02/01/1993-02/01/2013.
For illustrative purposes only and does not represent any specific Lord Abbett mutual fund or any particular investment.
Past performance is no guarantee of future results.
Treasuries are debt securities issued by the U.S. government and secured by its full faith and credit, Income from Treasury securities is exempt from state and local taxes.

In the current environment, however, the real yield on the 10-year note was -0.12%, as of late February 2013, while the latest annual reading on GDP growth indicated a 2.2% rate of expansion. Thus, with the potential for less intervention from the Fed, the real yield on the 10-year note could normalize to a level that is more consistent with the rate of economic growth.

Market Monitor
Major equity and fixed-income benchmarks for the week ended Friday, April 12, 2013

Although a return to the historical relationship between real Treasury yields and GDP growth could indicate price declines on government and government-related securities, several fixed-income asset classes have, historically, posted positive returns during periods of rising Treasury yields. For example, in the prior six periods when the 10-year Treasury yield rose by 100 basis points (bps) or more, the Barclays U.S. Aggregate Bond Index (three-quarters of which consists of government-related securities) posted a median loss of 0.79%. And during those same periods, several credit-sensitive asset classes—ranging from convertible bonds to short-term corporate debt—posted positive returns according to Morningstar as of March 31, 2013.

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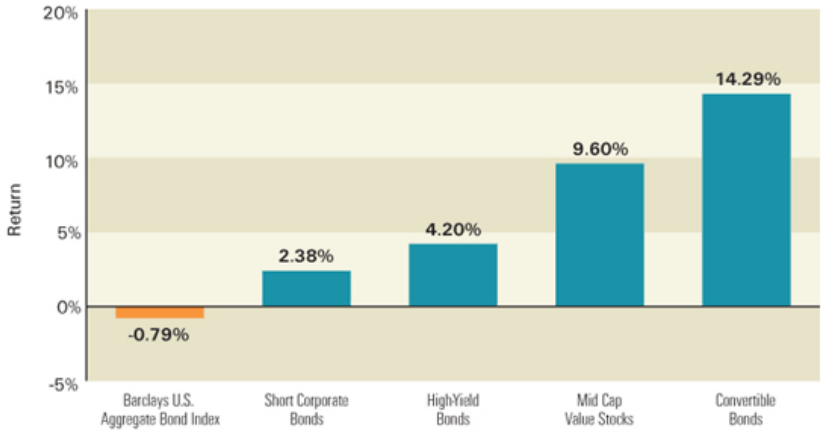
"The historical returns of both the [Barclays] Aggregate and credit-sensitive bonds during periods of rising interest rates emphasize that the interest-rate risk, rather than credit risk, may be the prevailing threat to bondholders in the current environment," said Zane Brown, Lord Abbett Partner and Fixed Income Strategist.

Select Asset Classes That Have Outperformed During Rising Rates

Median returns from last six periods where the 10-year Treasury yield rose by 100 bps or more (as of 03/31/2013)



Source: Morningstar.
Bond prices move inversely to interest rates: when interest rates rise, bond prices fall, and when rates fall, bond prices rise. Longer-term debt securities are usually more sensitive to interest-rate changes; the longer the maturity of a security, the greater the effect a change in interest rates is likely to have on its price. High-yield securities carry increased risks of price volatility, illiquidity, and the possibility of loss in the timely payment of interest and principal. Stock prices fluctuate, sometimes rapidly, and dramatically, due to factors affecting individual companies, particular industries or sectors, or general market conditions. Mid cap company stocks tend to be more volatility and less liquid than large cap company stocks. Convertible securities have both equity and fixed-income risk characteristics.
Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.
Past performance is no guarantee of future results.
Please refer to "Important Information" regarding the economic indicator data in these charts and index information.

IMPORTANT INFORMATION
All links are directed to Lord Abbett's website.

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Investors should consult with a financial advisor on the strategy best for them based on their individual goals, risk tolerance, and investing time horizon.

A Note about Risk: The value of investments in equity securities will fluctuate in response to general economic conditions and to changes in the prospects of particular companies and/or sectors in the economy. The value of investments in fixed-income securities will change as interest rates fluctuate. As interest rates fall, the prices of debt securities tend to rise, and as interest rates rise, the prices of debt securities tend to fall. Investments in high-yield securities (sometimes called junk bonds) carry increased risks of price volatility, illiquidity, and the possibility of default in the timely payment of interest and principal. Income from municipal securities may be subject to the alternative minimum tax. Federal, state, and local taxes may apply. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. Bond may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. No investing strategy can overcome all market volatility or guarantee future results.

Foreign securities generally pose greater risk than domestic securities, including greater price fluctuations and higher transaction costs. Foreign investments also may be affected by changes in currency rates or currency controls. With respect to certain foreign countries, there is a possibility of nationalization, expropriation, or confiscatory taxation, imposition of withholding or other taxes, and political or social instability that could affect investments in those countries. The securities markets of emerging countries tend to be less liquid, to be especially subject to greater price volatility, to have a smaller market capitalization, and to have less government regulation, and may not be subject to as extensive and frequent accounting, financial, and other reporting requirements as securities issued in more developed countries. Further, investing in the securities of issuers located in certain emerging countries may present a greater risk of loss resulting from problems in security registration and custody or substantial economic or political disruptions. Foreign currency exchange rates may fluctuate significantly over short periods of time. They generally are determined by supply and demand in the foreign exchange markets and relative merits of investments in different countries, actual or perceived changes in interest rates, and other complex factors. Currency exchange rates also can be affected unpredictably by intervention (or the failure to intervene) by U.S. or foreign governments or central banks, or by currency controls or political developments.

While municipal bonds are backed by municipalities, U.S. government securities, such as U.S. Treasury bills, are

considered less risky since they are backed by the U.S. government. High-yielding, non-investment-grade bonds (junk bonds) involve higher risk than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Although U.S. government securities are guaranteed as to payments of interest and principal, their market prices are not guaranteed and will fluctuate in response to market movements.

The credit quality ratings of the securities in a portfolio are assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities. Credit quality distributions breakdown is not a Standard & Poor's credit rating or an opinion of Standard & Poor's as to the creditworthiness of the portfolio.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

A **basis point** is one one-hundredth of a percentage point.

The Barclays U.S. Aggregate Bond Index is an unmanaged index composed of securities from the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment. Indexes are rebalanced monthly by market capitalization.

Short-term corporate bonds are represented by the BofA Merrill Lynch 1-3 Year BBB U.S. Corporate Index, which is a subset of the BofA Merrill Lynch U.S. Corporate Index including all securities with a remaining term to final maturity less than three years and rated BBB1 through BBB3.

High-yield bonds are represented by the BofA Merrill Lynch High Yield Master II Constrained Index, which is a market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment–in-kind securities. Issues included in the index have maturities of one year or more and have a credit rating lower than BB-/Baa3, but are not in default. The BofA Merrill Lynch U.S. High Yield Master II Constrained Index limits any individual issuer to a maximum of 2% benchmark exposure.

Mid Cap Value Stocks are represented by the Russell Midcap® Value Index, which measures the performance of those Russell Midcap companies with lower price-to-book ratios and lower forecasted growth values. The stocks are also members of the Russell 1000 Value index.

Convertible bonds are represented by the BofA Merrill Lynch All Convertibles All Qualities Index, which contains issues that have a greater than $50 million aggregate market value. The issues are U.S. dollar-denominated, sold into the U.S. market and publicly traded in the United States.

Nominal yield is the yield prior to adjusting for inflation. Bond yields are normally quoted as nominal yields. Yields that have been adjusted for inflation are called real yields.

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