"If the labour market continues to improve more quickly than anticipated by the Committee, resulting in faster convergence toward our dual objectives, then increases in the federal funds rate target likely would occur sooner and be more rapid than currently envisioned." –Janet Yellen, Chair of the Federal Reserve, June 2014.

At the very start of 2014, it was **widely expected to be a strong year for global equities** with an emphasis on the developed markets. **Fixed Interest investments (bonds) on the other hand were predicted to fall**, with investors expecting interest rates to rise in the wake of the Fed finishing its bond purchasing programme in October. This trend was the general consensus amongst institutions, and most expected that selling pressure would build for holders of US treasury (government) bonds and UK Gilts as **quantitative easing (QE) started to be unwound**.

However, markets have an uncanny knack of wrong footing a consensus investor in the short term, no matter how rational their decision making. True to form, **so far this year the stand-out performer has been "low risk" US government bonds**. So why have US treasuries performed so strongly at a time when yields on these assets was sitting at 30-year low?

The big freeze – US Economy stopped in its tracks
Source: www.theguardian.com

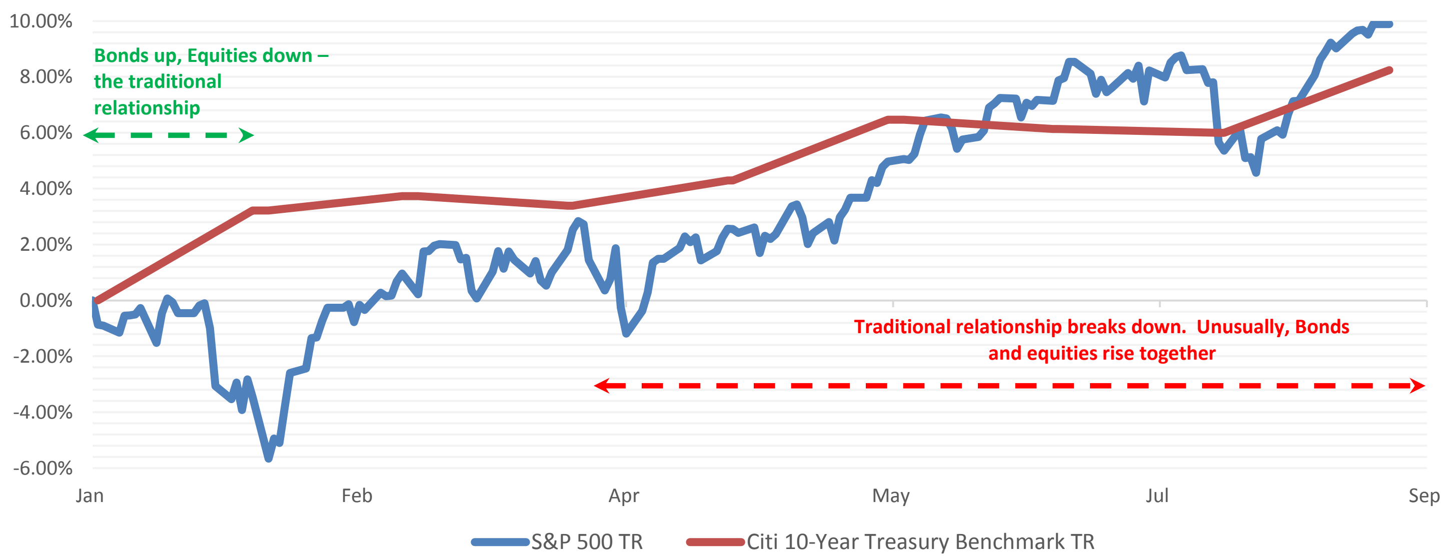
As we've suggested in previous missives, **geopolitical risks currently sweeping the globe** have certainly played a major part and the most sensitive concern has unquestionably been the Russian – Ukrainian conflict, most notably for the Eurozone, already weakened by stagnating growth. After the crisis escalated in January, it was perhaps no real surprise to see **investors fly into the relative safety of government bonds**. Likewise in the Middle East, the growing tension in Gaza and the surge of ISIS into Iraq gave nervous investors two additional reasons to be fearful.

Another factor that contributed to high demand for defensive investing in the first quarter of 2014 was the dreaded "polar vortex", freezing weather conditions in the US that brought most of the East Coast and further inland to a stand-still for almost a week. This had a **pronounced effect on short-term growth expectations in the US and as a result the economy contracted by an annualised 2.1% in the first 3 months of 2014** with US businesses suffering more than **$15bn of losses due to the freeze**. More justification then for a flight to safer investments in the first quarter of 2014, as 10-year treasuries generated a 3.38% total return versus 1.66% for the S&P 500.

However, even toward the end of March and certainly into April/May of this year sentiment towards US equities changed dramatically and as was predicted at the beginning of 2014, **US markets started to perform well again**. This was partly due to investors becoming desensitised to "old news" surrounding geopolitical factors, partly due to the US economy being more insulated from the fall-out of sanctions against Russia but also latterly due to the wider expectations that the US economy was starting to recover strongly from the poor first quarter. **By the end of June, the economy had grown by 4% (annualised), more than recovering the lost ground of Q1**. Meanwhile growth in earnings per share for S&P 500 companies stood at a **record 9% on average, completing six consecutive quarters of record corporate earnings growth**.

As might be expected, this **triggered a rally in US equities** but surprisingly there was **no negative impact on US treasury bonds**. In fact we witnessed quite the opposite as treasuries continued to rally alongside equities.

S&P 500 equity index vs. 10-year US Treasuries index



For example the **iShares 7-10 Year Treasury Bond ETF, a retail investment fund, attracted $2.2 billion of new money in the second quarter**, the biggest flow of new funds into any of the enormous pool of US bond ETFs. This was surprising because typically **you'd expect that US government bonds and equities will rise and fall in opposite directions** because a growing economy should mean healthy demand for equities and selling pressure on less risky bonds. **There has been considerable debate as to why both "risk-on" equity and "risk-off" bond assets started to both increase at the same time**. Whilst the performance of US bonds through Q2 was less pronounced than the resurgent S&P 500 10-year **treasuries ended the first half of the year up an impressive 6.13% compared to the S&P's 6.81%**, an incredible performance from a low risk asset class. To appreciate the logic behind this strange correlation requires analysis of economic activity elsewhere around the globe at the time.

Firstly, notwithstanding good returns from emerging market equities this year, the **general ongoing withdrawal of assets from emerging markets since last May has meant that the US and UK have been major beneficiaries of this move as investors poured money both into equities and bonds.**

Secondly, even with such strong flows into US treasuries earlier in the year, let us not also discount the fact that **US bonds offer a much more attractive yield than their German and Japanese counterparts**. Even Spanish government bonds yield less than US treasuries! German 10-year government 'bunds' were yielding 1.16% as of 31st July and Japanese 'JGB' 10-year bonds offered a miserly 0.54%. Meanwhile 10-year US treasuries offered a much more attractive 2.56%. For anyone anticipating a rally in the US dollar then, **buying US bonds offered both a better annual yield and exposure to their currency of choice**.

Thirdly, due to increased regulation, **US banks are being forced to increase capital** on their balance sheets by $100bn in total. **Many are therefore buying US treasuries in the short term to plug the gap.**

Finally, and in our opinion more importantly, **investors have realised that the US dollar has been pushed too low against other major currencies and as a result we have seen large flows back into the greenback, particularly over the last few months**. Rather than simply switching between paper currencies, because cash interest rates are so low, many **investors have decided to obtain their USD exposure by buying US treasury bonds instead**.

On this last point, investors should note that recent talk about Scottish devolution has already put further pressure on sterling.

Arguably therefore, **treasury strength has been a direct result of demand for US dollars** rather than because US treasuries themselves look good value. **The dollar has appreciated about 5% against the Euro this year and over the last few months it has also strengthened against sterling from 1.70 to 1.64**.

Since the end of Q2, US bonds had an underwhelming July but bounced strongly in August. Continuing the strange trend of positive equities and bonds, the **S&P 500 also broke through 2000 for the first time ever on 26th August, completing a month where corporate earnings for firms in the index rose a further 12%.**

So what have we been doing to take advantage of stronger demand for US assets in general and a strengthening US dollar?

We've preferred to invest our US exposure through the equity markets and US high yield bonds rather than the government bond markets.

Given how well the US economy has performed compared with others, the very **long-term outlook for US businesses is still very strong**, with very low rates of default and despite the short-term turbulence that we have seen this year **we will continue to invest as long as the fundamentals remain in place**.

Inflows into US stock markets have been very healthy, especially when compared to other developed market indices and many sectors in the US are in rude health, with companies taking advantage of the drop in prices earlier this year to buy-back their own shares.

In comparison, as above **the prospect for government bonds generally does not look as promising** and in our view, US treasury bonds' strength can only continue in the short-term. There is **considerable uncertainty surrounding short-term interest rates, particularly in anticipation of the Federal Reserve finishing its bond purchasing programme. Furthermore, if unemployment falls faster than anticipated, the Fed may well look to move aggressively to raise interest rates earlier than planned, although this seems unlikely**. Having participated in all of the uplift in US asset values via equities and corporate bonds rather than US government bonds, **we'd certainly be selling treasuries now if we owned any.**