July 8, 2013

Dear Client,

In the most recent quarter, the long awaited reversal (decline) in bond prices began, and in fairly dramatic fashion. The interest rate on the 10 year U.S. Treasury bond increased from 1.66% to 2.60% in a period of less than 2 months. This translates into a decline in price for that security of a bit more than 7%. Prices for other types of bonds, such as municipal, mortgage, corporate and high yield, declined as well.

The trigger for this event is mostly attributed to a change in commentary by the Federal Reserve Board, as the outgoing chairman outlined the thresholds that must be met in order to begin to withdraw the extraordinary monetary stimulus that is currently in place. Please note that the Fed did not start withdrawing stimulus but just outlined the hurdles that must be cleared in order to do so.

However, this was enough to spook market participants, which has lead to significant withdrawals from bonds and bond focused investment funds. Once started, selling begets selling. At first all asset classes were affected, stocks as well as bonds, in what is known broadly as deleveraging. After a few weeks there was a de-coupling whereby stocks recovered while bonds continued to sell off. That is where we find ourselves now.

Of course, one cannot be sure if this is a short-term adjustment or the beginning of a long-term trend. The lack of global economic strength and the low reported inflation rate argues for stabilization, or possibly a decline, in rates. As such, I have been using the increase in interest rates to add to bond holdings in a nibbling fashion. If rates continue to climb, I will continue to add.

As for quarterly investment performance, my accounts on average kept pace with the stock indices even with much less stock market exposure. The selloff in bonds had little impact as the portfolios I manage have very little interest rate risk. Enclosed please find your Second Quarter of 2013 portfolio report. Please contact me if you have any questions.

I hope you have a wonderful summer.

Best regards,

Peter V. Hedberg