

Up, Up



and Away?

With interest rates at rock bottom, investors worry that bonds are in bubble land. Here's how to deal with what comes next.

Asset prices have a long history of overshooting their fair value. Sometimes by a lot. Recently, of course, speculative bubbles inflated and popped in dotcom stocks, crude oil and residential real estate.

They may be all air, but getting hit by a bubble can be painful — for investors. And as long as there are assets to trade and fallible human beings to trade them, there *will* be bubbles.

Which begs the question: Could bonds be the source of the next bubble trouble?

A reasonable question, to be sure. The Federal Reserve has pushed short-term rates to the floor, so there's nowhere for them to go but up. Since bond yields are indirectly tied to Fed policy, higher benchmark interest rates could reverse the rally that's been unfolding in bonds during most of the last three decades.

Or maybe not.

"We don't think bonds are in a bubble," says Bill Dennehy, senior fixed income portfolio manager for Northern Trust. "Treasury yields are low, but so is inflation. Plus, U.S. government debt is still seen as a safe haven in a very uncertain world."

Yet there is cause for concern. Bubbles inflate when buyers become overly aggressive and lose all sight of value. Seeking shelter from the economic storm, fixed-income investors have poured vast sums into bond funds during the last two years.

But when the economy began to show a pulse in March 2009, yields on 10-year governments abruptly rose from 2.5% to nearly 4% before falling back.¹ Investment-grade and high-yield bonds did well though — in some cases, spectacularly well — even as Treasuries tanked.

There's a lesson to be learned from that

divergence. If a bubble formed in one area of the bond market — Treasuries would seem to be the most likely candidate — it wouldn't necessarily mean that other areas are equally vulnerable.

"The bond market is comprised of several sectors and they don't always move in lock step," says Northern Trust senior product manager Peter Jacobs.

And don't conclude from the low nominal yields on Treasury bonds that they are necessarily in for an imminent comeuppance. "In the unlikely event that the global recovery falters, Treasuries would be a main beneficiary," Dennehy says.

Golden era

The total return from a bond mutual fund comes from two components: the income generated by securities in the portfolio, and changes in their market

price. Because coupons on traditional bonds are fixed, the value drops if investors can get a better yield on newly issued debt of similar credit quality and maturity. In other words, bond prices go down if yields go up.

Ideally, investors would buy bonds when yields are high — thus locking in a generous income stream — then watch the price rise as interest rates declined.

That is what happened during the quarter-century that began in the early 1980s, when then-Fed Chairman Paul Volcker allowed short-term interest rates to fall from sky-high levels after taming the inflationary beast that had bedeviled the American economy since the late 1960s. Between 1981 and 2009, long-term Treasury yields fell from 15.8% to about 2%.²

But some analysts wonder if that decades-long tailwind is about to become a headwind. After all, between 1962 and 1981, those same yields moved up from 4% to nearly 16%³ as inflation rose and the Fed tightened monetary policy to control prices.

One way that bonds could suffer would be from a rise in inflation. With some yields near generational lows, it wouldn't take a 1970s-like outbreak to push the value of fixed-income investments lower.

The bull market in gold reflects fears that financing large budget deficits here and abroad with printed money will spark another bout of unacceptable inflation.

But Dennehy thinks that inflation worries are overblown, at least for now. "Resource utilization is low and we don't see that changing soon," he says.

Indeed, the capacity utilization rate of American industry is 6 percentage points below its long-term average⁴ while roughly 16% of the domestic labor market is either unemployed or underemployed.⁵

Not surprisingly, core inflation in the United States recently dropped to under 1%, its lowest level since 1961.⁶

"It would be unusual to get a big rise in inflation or inflationary expectations under current circumstances," Dennehy says. "Inflation becomes a problem when available workers are scarce and factories are running at full capacity." He notes that the Fed could quickly squelch any inflationary outbreak by selling assets from its balance sheet.

The weak housing market also could help bonds. Even under a best-case scenario, Dennehy thinks house prices will remain stagnant for several years. The withering of the wealth effect from real estate should keep a leash on consumer spending, thereby exerting still more downward pressure on inflation and employment.

Lesson learned

Another potential menace to bond prices — tighter monetary policy — also seems unlikely this year. Fed Chairman Ben Bernanke is an ardent student of the Great Depression and subscribes to the theory that premature tightening made it worse. Similar claims have been made about Japan in the 1990s.

"This Fed will be careful to avoid making those same mistakes," Dennehy says.

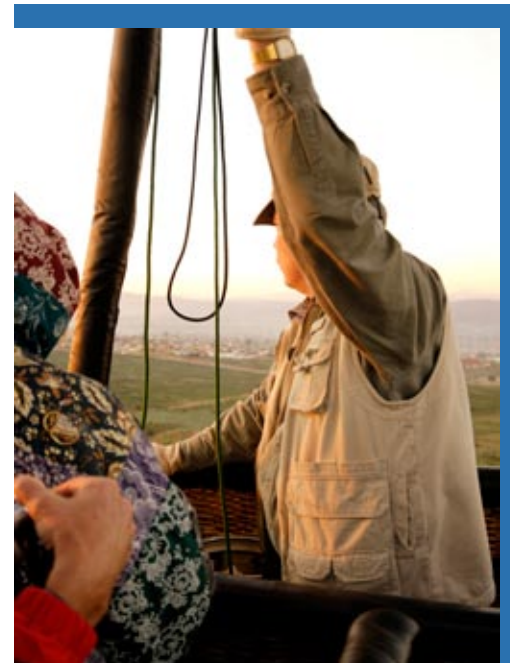
Still, Dennehy acknowledges that 10-year Treasury yields of around 3% as

of mid-year may be too low based purely on economic fundamentals. Eurozone debt and solvency issues sparked a run on U.S. government securities last spring, a trend that could end if and when European financial conditions stabilize.

Even then, however, Dennehy sees Treasury bond yields inching higher to still-low levels compared with those of the last two decades. That's because government bond yields aren't unreasonably low in real, or inflation-adjusted, terms.

Yet another concern is the supply of government bonds, which has exploded in recent years. But while supply is always a factor, the impact of Treasury issuance may be less than is widely believed.

In the 1980s, bond yields plummeted even as federal deficits ballooned. In the late 1990s, yields rose despite budget surpluses.⁷ Dennehy also notes that



"The bond market is comprised of various sectors and they don't always move in lock step."

Peter Jacobs, Senior Product Manager, Northern Trust



Large Menu

Getting the most bang for your fixed-income dollar requires having lots of choices regarding maturities, issuers and tax consequences. Northern Funds offers 16 fixed-income mutual funds to help clients diversify their fixed-income holdings. There are actively managed funds from the tax-exempt, corporate and global sectors, a fund indexed to the broad domestic bond market, and a multi-manager high-yield fund. Having numerous options makes it easier to target your asset allocation decisions. For more information on how Northern Trust's fixed-income mutual funds can work for you, please contact your financial advisor or visit northernfunds.com.

Mutual fund investing involves risk, including loss of principal.



Uncle Sam may have overstated its near-term financing needs since tax receipts and TARP repayments have exceeded expectations.

Besides scant inflation, high unemployment and meager economic growth, Dennehy sees another reason for bond yields to stay low by historical standards.

“There aren’t many other places for money to go,” he says. “By keeping short-term rates near zero, the Fed has forced investors to flee cash unless they want to earn a negative real return.” Equities and convertible bonds might gain as well from a continuation of benevolent monetary policy.

The economy also is contending with the headwind of deleveraging, or the paying down of debt. According to Jacobs, households are still in the early stages of a process that typically lasts between five and seven years. Paying off old bills makes less money available for new ones.

Finally, demographic trends could benefit fixed-income investments as the 78 million-member baby boom generation reaches retirement age. Many boomers will need the income that bonds produce to maintain their lifestyles.

By one account, Americans have 10 times more invested in equities and real estate — neither of which produce a lot of income — than in bonds.⁸

“The demographics are very favorable for fixed income,” Dennehy says.

Why, why, why?

If and when air does start to leak out from the alleged bond bubble, how fixed-income investors fare could also depend upon why rates or inflation are rising.

“Why it happens matters because the answer will impact the various sectors of the bond market differently,” says Jacobs. “If rates or inflation increase because economic growth is strong, Treasuries could be hurt, but investment-grade corporates could hold their own while convertibles and high yield might actually rally.”

He notes that high-yield bonds are affected less by the price of money

and more by whether issuers have the money to pay back creditors. The same conditions that might cause inflation to increase or the Fed to raise rates could boost corporate cash flows.

Keep in mind, too, that bond income cushions price declines, which explains why the total return from the Barclays Aggregate Bond Index has been negative only twice since 1990, each time by less than 3%.⁹ (See chart, page 5.) As rates rise, the yields on most fixed-income mutual funds rise as well.

There are concerns about the health of the municipal sector, whose finances have been strained by the recession. Scary headlines about massive budget deficits in California have stoked fears about a looming day of reckoning.

But municipal bonds have a strong credit history, and professional management could make an important difference there and in other areas of the bond market.

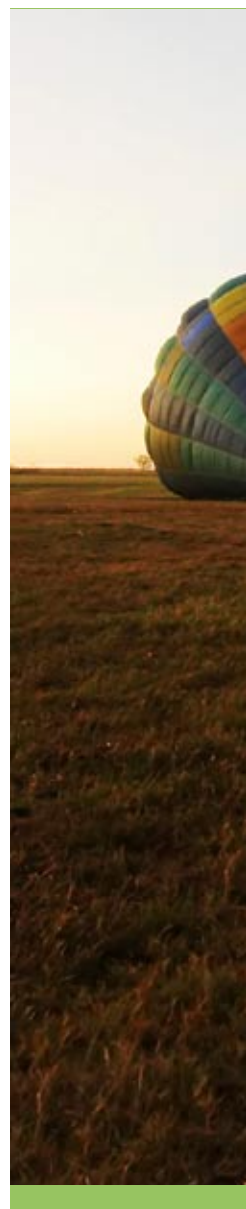
Returns from individual bonds can vary by a large amount. In 2002, the 25 best-performing investment-grade issues returned an average of 6%. That same year, the 25 worst-performing investment-grade bonds lost an average of nearly 20%.¹⁰

“Security selection makes a big difference in the bond market,” Dennehy says. “Our culture at Northern Trust emphasizes quality and creditworthiness rather than chasing the highest yield.”

Fear not ...

Even though the next 30 years almost certainly won’t be as fruitful for bond investors as the last 30, fixed-income investments should continue to play an important role in maintaining a diversified portfolio.

“One of the lessons of the last decade is that those



investors who overlooked the stability that bonds can provide took serious hits,” Dennehy says. “It is critical to have a thoughtful allocation within the fixed income portion of your portfolio to prepare for when rates eventually do start to rise.”

Yet Dennehy says that bondholders shouldn’t fear a global recovery. In fact, quite the contrary.

“Everyone would benefit from a sustained economic rebound,” he says. “Credit concerns would recede, which would be helpful for fixed income,” he says.

Though understandable given recent history, it would be a mistake to view every

extended rally in an asset class as a bubble.

“Air can come out of a balloon slowly and without popping it,” Dennehy says. “A gradual normalization of yields is a more likely scenario than a spike upward.”

That would be good news for bondholders looking for stability and income.

So stay tuned — and stay diversified. ■

Past performance is no guarantee of future results.

¹ Federal Reserve.

² Federal Reserve.

³ Federal Reserve.

⁴ www.federalreserve.gov/releases/g17/current/

⁵ Alan Abelson. “A True Horror Story.” *Barron’s*, July 5, 2010. Page 7.

⁶ John Authers. “Spectre of Deflation Is Back to Haunt Investors.” *Financial Times*, June 26–27, 2010. Page 16.

⁷ David Rosenberg. “Predictions of a Bond Market Bubble Are All Wrong.” *Financial Times*, June 22, 2010. Page 20.

⁸ David Rosenberg. “Predictions of a Bond Market Bubble Are All Wrong.” *Financial Times*, June 22, 2010. Page 20.

⁹ Barclays Live.

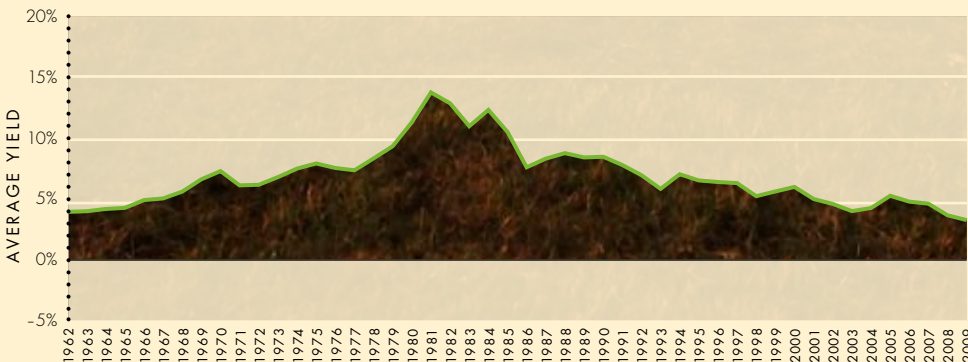
¹⁰ “Multisector Strategies in a Rising Rate Environment.” InvestestNews webinar. April 7, 2010. Loomis/Sayles.



Rate Rollercoaster

After rising sharply in the 1960s and '70s, bond yields have fallen for most of the last 30 years.

Average Annual Yield of 10-Year U.S. Treasury Note

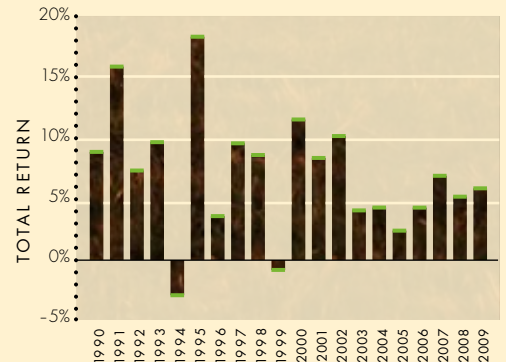


Source: Federal Reserve

The Income Cushion

Domestic bonds have experienced only two negative years since 1990.

Barclays Capital U.S. Aggregate Bond Index



Source: Barclays Live

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