The Bond Market Panic

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Given the elevated level of the bond market, "the bond market panic" may sound like a preposterous term, but it is appropriate since there is a manifest absence of yield. Judging by the iShares Barclays Aggregate Bond Fund (AGG), an exchange-traded fund ("ETF") which purportedly mirrors the investment-grade taxable bond market in the United States, the average yield to maturity is 1.8% and the weighted average maturity is 6.4 years. Of the holdings in AGG, 36% mature within five years[1].

If that fund actually mirrors the bulk of the U.S. bond market, a certain amount of income will be difficult to replace in the next five years. The table below depicts the coupons of the top 10 holdings of the AGG portfolio. The coupon on each and every bond, all of which are Treasuries, is in excess of the average yield to maturity of this fund.

The second largest holding in this fund is a Treasury bond bearing a 7.5% coupon that matures on November 15, 2016. Using that bond as an example, unless rates are 7.5% in four and a half years, it will be impossible to replace the income derived from that one holding. Generally, since all of these bonds trade above par, unless rates decline further, the unit value of this portfolio will gradually and inexorably decline. The weighted average coupon of this fund is 4.36%.

iShares Barclays Aggregate Bond Fund (AGG) Top 10 Holdings

	Coupon	Maturity
1.	4.75%	5/15/2014
2.	7.50%	11/15/2016
3.	3.62%	2/15/2020
4.	3.12%	8/31/2013
5.	8.12%	8/15/2019
6.	3.38%	7/31/2013
7.	7.62%	2/15/2025
8.	4.62%	2/15/2040
9.	2.38%	9/30/2014
10.	1.88%	10/31/2017

Source: iShares website week of 4/23/2012.

According to SIFMA (the Securities Industry and Financial Markets Association), the total U.S. bond market size as of the end of the fourth quarter of 2011 was $36.6 trillion[2]. Note that this figure includes such instruments as tax-exempt municipal bonds and high-yield corporate bonds, which are outside the scope of the Barclays Aggregate Bond Index. However, for the purposes of this example, we will assume that AGG serves as a proxy for the bond market reality. Making that assumption, 36%, or $13.2 trillion of the aforementioned sum calculated by SIFMA, will mature within 60 months.

[1] http://us.ishares.com/product_info/fund/overview/AGG.htm
[2] http://www.sifma.org/research/statistics.aspx

If the average coupon on the maturing bonds is 4.36%, and they are replaced by bonds with coupons of 1.70%, then the cash flow of the bond market itself would be reduced by 2.66% of $13.2 trillion, or $351 billion every year. That dollar amount is equal to 2.51% of the United States' current annual gross domestic product ("GDP"). Of course, it seems reasonable to suppose that the actual number might be higher because, for the purposes of this calculation, the weighted average coupon is being used. What should be used is the average coupon maturing in the next five years, which is probably a higher number than the average coupon of the whole portfolio. In any case, a minimum of $351 billion of income will be lost to the American bond investor when this process is completed.

In addition, much of this income is being lost by tax-exempt entities. Imagine what the reaction would be if the United States government were to place a tax of such a magnitude upon all the tax-exempt institutions in the nation. Arithmetically, this is actually happening even though the government does not plan any such action. The reality of that loss is likely to compel the holders of those bonds to look to other asset classes or investment strategies to achieve the yields they require.

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