



September 13, 2010

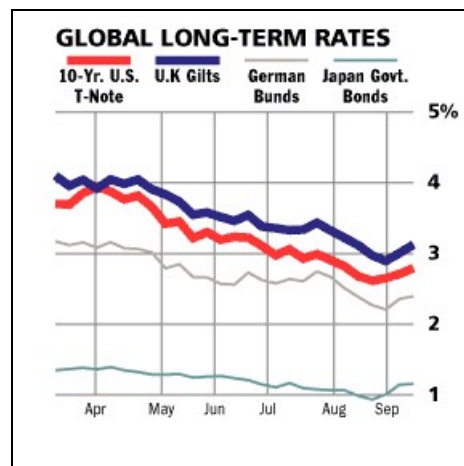
## *A Sign of Things to Come?*

As investors enjoyed the last days of summer and returned to reality last week after Labor Day few noticed what had been happening in the bond market. In a matter of 2 weeks the benchmark 10 year U.S. Treasury Bond has declined in price 2.5% and its yield had jumped from a recent low of 2.41% to 2.79% last Friday. Investors who have stamped into the bond market the last 18 months might be on the verge of getting a wakeup call on the real cost of “Safety”. The decline on paper of the price of the 10 year bond since August 25 has nearly wiped out a year’s worth of interest. The sell off coming as the worries over the European credit crisis and a double dip U.S. recession have moderated. These economic drivers have rallied the U.S. Treasury market straight up for nearly six months.

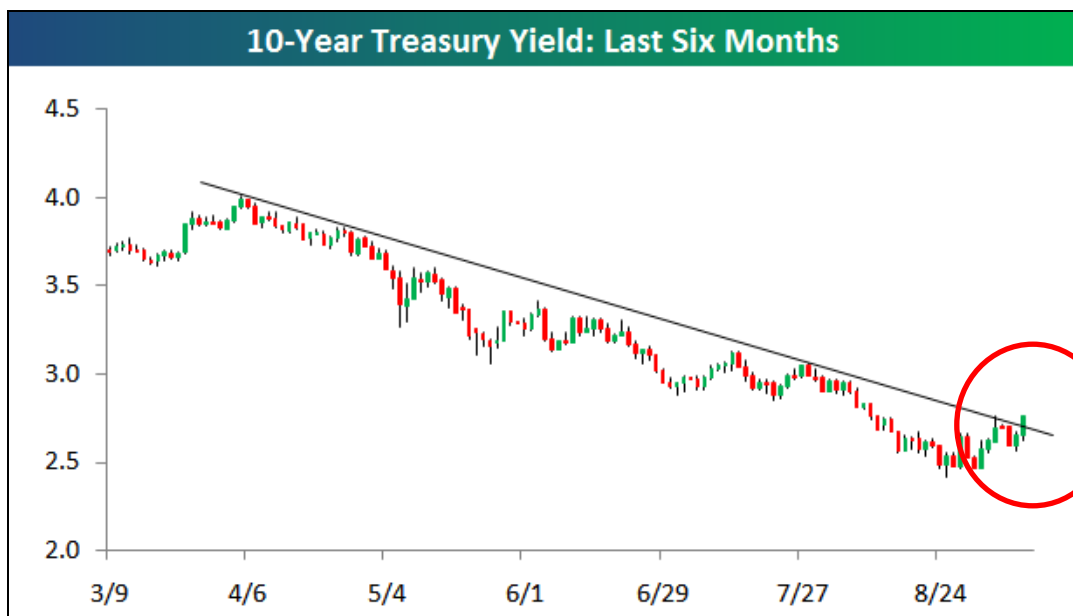
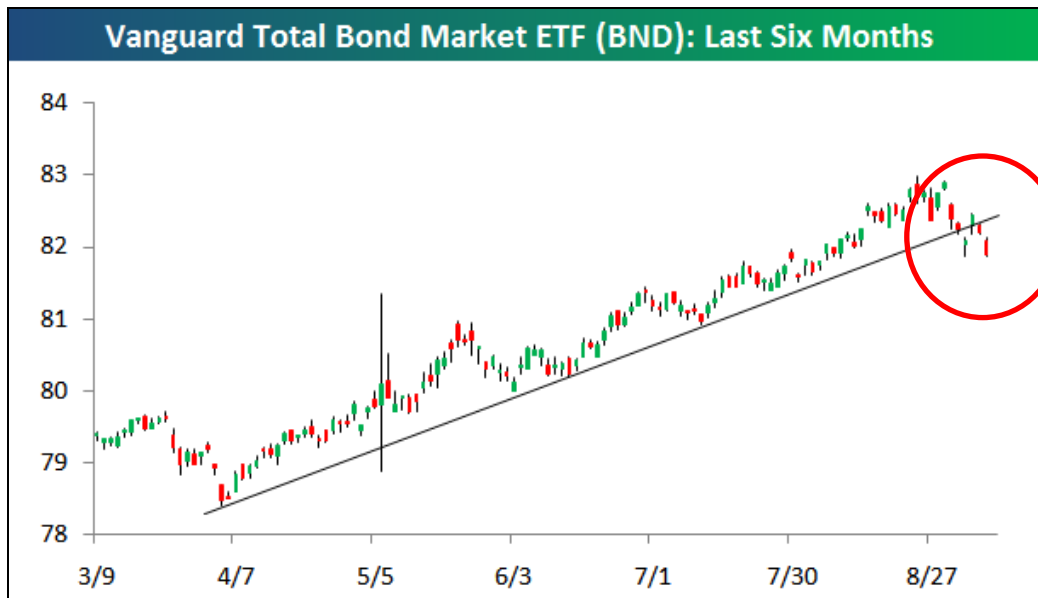
The bond bulls have overwhelmed the market continuing to pour record dollars into fixed income. According to The Investment Company Institute, a national association of mutual fund companies, in 2009, a net \$376 billion dollars went into bond funds. This is in comparison to a previous 10 year average of \$42 billion per year. For those statistically minded this is over three standard deviations from the norm, a very alarming number. So far in 2010 over \$184 billion of new money has gone into the market via bond funds. These significant numbers do not include the explosion of new dollars in Exchange Traded Funds (ETF’s) which have amplified this trend.

Although still in the minority, the talk of a “Bond Bubble” is surfacing more and more in the media. For those that follow MPI, you know that we have been cautious for some time, discussing the issue of higher rates at year end 2009 and again in a white paper in March.

The market action the last 2 weeks could be shifting talk to reality. In the *Current Yield* section of this week’s Barron’s magazine, a Global Long-Term Rate chart shows that this recent uptick in rates is not just confined to the U.S. The UK, Germany and Japan have all experienced the same yield rally/price decline.



A more concerning trend was highlighted late last week on the investment industry trade website; *Seeking Alpha*. Although MPI's investment style is not driven by technical indicators, many Wall Street investors follow these closely. In the last 2 weeks there has been a break in the long term technical up trend of both the Vanguard Total Bond Market ETF (BND) and, not surprisingly, the 10-Year Treasury Yield.



These reversals are in very early stages and could correct themselves, but they are currently pointing to a trend that could be very significant and signal difficult times ahead for those invested in long term bonds. When a higher rate cycle begins history tells us increases can occur quickly. In 1994 the Fed raised the discount rate 9 times from 3% to 6% in a 12 month period. The 30 year U.S. Treasury Bond yield went from 6.2% to 8% and the bond price declined 19%.

MPI is not predicting that this is the top of the bond market. But with prices at historical highs one does not have to go too far out on a limb to suggest the next trend will be in lower bond prices and higher yields. The reality is *not if rates will rise but when and by how much*. Obviously economic indicators will drive the timing of this process and the economy is still struggling. But it is also important to remember that markets are forward looking and often begin to reflect future economic conditions prior to being seen in historical data.

As we have stated before; proper security selection in a rising interest rate environment is critical. The longer average maturity that your portfolio has the more risk you are taking. Mistakes can result in severe long term damage to an investor's portfolio. Locking in longer maturities will not allow a portfolio to increase its yield without taking losses in those positions. In this cycle it is critical to also understand the size of the bond mutual fund marketplace is several times the norm. When rates rise it will send some investors to the sell window in an effort to shorten up maturities. This could cause liquidity and volatility issues in the current overbought mutual fund bond market.

The time to review your fixed income portfolio is now. Shortening your bond portfolio's average maturity, whether you are in individual issues, funds or ETF's will pay off in the future. When rates begin to rise you will be able to "walk up yields" in your portfolio and improve your total return picture.

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**David W. Pequet**, 58, founded the advisory firm MPI Investment Management, Inc. in 1986. MPI manages over 250 million dollars of primarily fixed income institutional and high net worth portfolios in the United States and in Europe. During the last two decades MPI has been nationally recognized several times for its fixed income investment management. Prior to starting MPI Mr. Pequet specialized in fixed income at several Wall Street securities firms including Prudential-Bache and Mosley Securities. He earned an Engineering degree from Michigan State University in 1974. Following college Mr. Pequet was in the Naval Aviation Officer Flight Program. For the last 25 years Mr. Pequet has been active at the executive level in several community and youth programs in the Hinsdale Illinois area, including 8 years as a board member of the Oak Brook Plan Commission, 6 years as coach and Director of the Hinsdale Little League, and has been a Director and Treasurer of the Hinsdale Public Library Foundation for the last 7 years. Mr. Pequet has been active for 25 years with the Roger B. Chaffee Scholarship Fund in Grand Rapids Michigan as both a Director and Treasurer. David is a member of The Bond Club of Chicago. In recent years he has been quoted and interviewed by Chicago Crain's Business Magazine, Investment News and The Wall Street Transcript. Mr. Pequet has been married to Christine since 1976 and they have two son's both in the investment business.



MPI Investment Management Inc., [www.mpi-invest.com](http://www.mpi-invest.com) 800-237-0930  
15 Salt Creek Lane, Suite 404, Hinsdale, IL 60521

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