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UPDATE

What Is A Negative Real Yield?…And Why You Don't Want One…

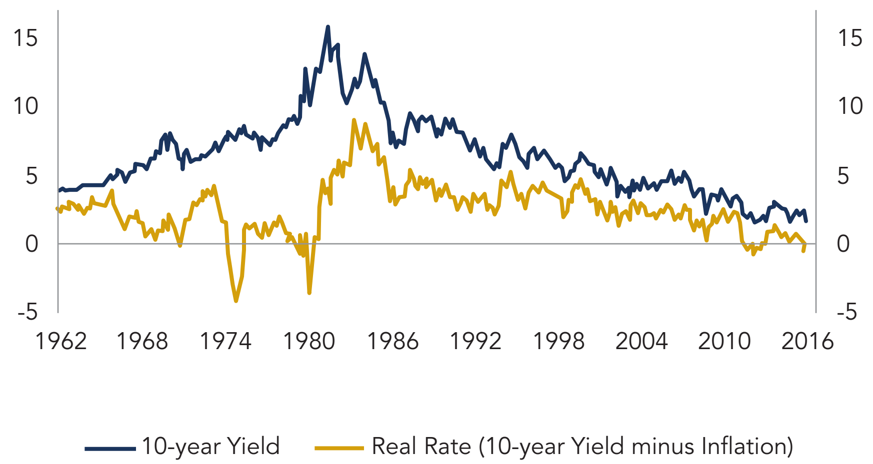
Never heard of negative real yields? No, you didn't sleep through that class back in college! They are not that common, and exceedingly rare in longer term bonds.

The interest rates that we normally discuss are called NOMINAL rates in economic parlance. Real rates are defined as the Nominal Rate minus the Inflation Rate. In other words it is a measure of purchasing power protection afforded by the yield on a fixed income security. For instance, the 10 year US Treasury Note currently yields about 1.80% and Core CPI is running around 2.1%, so….1.80% - 2.10% = -0.30% or a negative real yield of -.3%. So what does this mean? In simple terms, it means that (assuming inflation averages 2.1% over the life of the note) your purchasing power on the amount invested will decline by 0.3% every year you hold the note. Not exactly compelling from a principal protection standpoint!

Not surprisingly, it is extremely rare that 10-year Treasury yields are lower than the rate of inflation. As you can see on the chart, we have not witnessed negative real yields since 2013 (and only twice before that back in the '70s and '80s). This was just prior to the Federal Reserve's discussion of tapering asset purchases. The willingness of the Federal Reserve to adjust policy caused a violent repricing in 10-year yields.

Look closely at the chart below, you can see why we disagree with those that argue that long term rates are destine to stay long for an extended period and instead expect yields across the curve to adjust upward. Historically, negative real yields just don't last very long! There are only two ways for this to correct itself. First, inflation could collapse, so you are subtracting a smaller number from the nominal rate. We see inflation averaging around 2% long term so we don't see this as likely. So the only other way for real yields to revert to a positive number is for NOMINAL yields to increase. Which should happen as the Fed goes through the rates normalization process.

Real Rates vs 10-year Treasury



Source: Bloomberg

Economic Review

In May the S&P 500® was up 1.8%, puttingthe Index up 3.6% year-to-date. Over the course of this year, the market has seen major rotations among sectors, as the psychology has flip flopped from defensive to aggressive. Nowhere has the fickleness of the market been more evident than in investor reaction to Federal Reserve action. A year ago even the thought of a quarter-point hike in the fed funds rate caused a wave of nervous selling. Lately, the Fed's hints to prepare for another quarter-point rise this summer have been received as just more positive news that the economy is on solid footing. Indications that the second quarter GDP should show an acceleration from the flat first quarter supports both the Fed action and the overall optimism.

While the domestic economy lumbers ahead, once again one of the weights on stock and bond markets has been international concerns. Worldwide markets are digesting Great Britain's exit from European Union (Brexit). Meanwhile, economic pressures continue to percolate in China, which some observers consider to be in the midst of a recession. The Chinese yuan has followed its pegged currency, the U.S. dollar, to high levels against the rest of the world's currencies. This has set the stage for another round of yuan devaluation. The U.S. imports more goods from China than any other country, and further devaluation would mean cheaper

"I'm getting subtle hints of what the Fed might do."

prices on these imports, which spells tougher competition for U.S. companies. Further, central banks in Europe and Japan continue to seek additional stimulus, with the European Central Bank gearing up for a round of quantitative easing via corporate bond purchases. So far such efforts have been insufficient to bring these major economies around, putting the U.S. into the world's economic growth lead, despite its modest rate of expansion.

Another source of uncertainty is the upcoming elections, which seem to be a concern investors have set aside for the moment. Depending on how the projections and polls shake out, this could ramp up in importance as we head towards November. It's difficult to say how the election will affect the markets, but if the past is any indication, the direct impact on the sorts of individual companies in which Madison invests should be minor. The companies we invest in appear to be in a good position to continue to produce solid results in a slowly expanding domestic economy, despite challenges overseas. As we head into the second half of 2016, the political environment will be an additional consideration that we'll employ as we continue to carefully monitor the business metrics and prospects of each of your holdings.

Bonds are subject to certain risks including interest rate risk, credit risk and inflation risk. Equity risk is the risk that securities will fluctuate in value due to general market or economic conditions.

An investment cannot be made directly into an index. Nothing contained herein is intended to be a recommendation to buy or sell any security. Nothing contained herein is intended to represent the performance of any Madison Fund or product. Past performance is no guarantee of future results.

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