Bond Market Perspectives

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Ride the Yield Curve

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Highlights

Recent events in Cyprus coupled with higher valuations among lower-rated bonds illustrate that high-quality bonds can still play a role in investor portfolios.

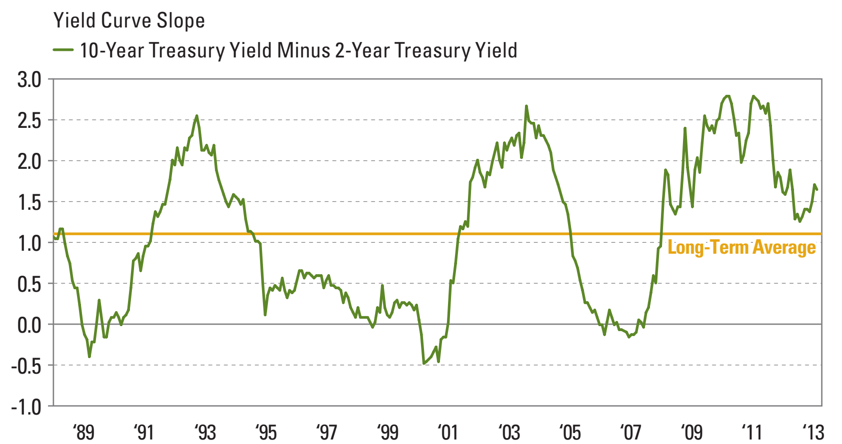
A potential opportunity may exist among high-quality intermediate bonds following year-to-date strength in lower-rated bonds, a corresponding rise in high-quality bond yields, and ongoing Federal Reserve (Fed) policy.

The yield curve, a graphical representation of yields across the maturity spectrum of the bond market, has long received attention as a relatively good leading economic indicator. A flat or inverted yield curve has often predicted an economic slowdown or recession, while a steep yield curve foreshadows economic growth.

However, the shape of the yield curve can impact total returns for bond investors and help determine which maturity segments — short, intermediate, or long-term — of the bond market offer the most attractive potential reward for a given amount of interest rate risk. The year-to-date rise in high-quality bond yields coupled with the current shape of the yield curve may offer investors an opportunity in high-quality bonds.

The yield differential between 2- and 10-year Treasury yields is one of the most common measures of whether the yield curve is "steep" or "flat". The greater the yield differential between 2- and 10-year Treasury yields the "steeper" the yield curve, and conversely, the narrower the yield differential, the "flatter" the yield curve is considered. Currently, the yield curve is moderately steep based upon the yield differential between 2- and 10-year Treasury yields but well off an historically steep yield curve in recent years [Figure 1].

1 The Yield Curve Remains Moderately Steep Compared to History

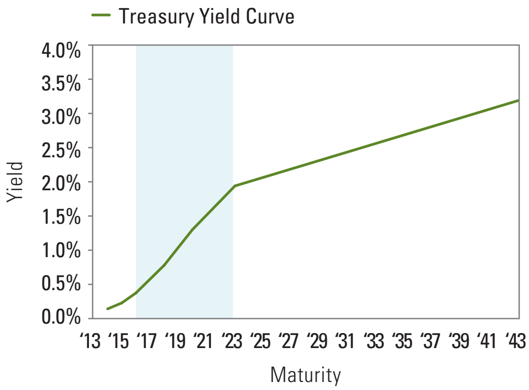


Source: Bloomberg, LPL Finanical 03/15/13

Beginning 01/01/1988.

For the purposes of this publication, 'high-quality' as it refers to bonds denotes a Moody's rating of Baa3 or higher and S&P rating of BBB- or higher and is broadly represented by the Barclays Aggregate Bond Index.

2 The Yield Curve Is Steepest Between 3- and 7-Year Maturities



Source: Bloomberg, LPL Financial 03/18/13

Shade area indicates the steepest portion of the yield curve and therefore the greatest yield differential between the above-mentioned yield maturities.

3 Fed Policy Has Led to Short-Term Yield Stability

Maturity (Yrs)	Yield 12/31/2012	Yield 3/18/2013	Change
1	0.14	0.13	-0.01
2	0.25	0.24	-0.01
3	0.35	0.37	0.02
5	0.72	0.79	0.06
7	1.18	1.29	0.11
10	1.76	1.96	0.20
30	2.95	3.19	0.24

Source: Bloomberg, LPL Financial 03/18/13

4 Treasury Total Return Scenario Analysis

		Change in Treasury Yields			
		-0.25%	0.00%	0.50%	1.00%
Treasury Maturity	4-Year	2.6	1.2	-0.3	-1.7
	5-Year	2.6	1.7	-0.3	-2.2
	7-Year	4.1	2.8	-0.1	-2.9
	10-Year	5.8	3.8	-0.4	-4.4

Source: Bloomberg, LPL Financial 03/18/13

Chart shows projected total returns for selected maturity Treasury bonds over a one-year holding period and various shifts in interest rates from a decline of 0.25% to a rise of 1.0%. Total returns assume parallel shift of the yield curve and no reinvestment of interest income.

Federal Reserve (Fed) policy has greatly influenced the yield curve since late 2010 when the Fed extended the maturity of its bond purchases. Part of the Fed's unconventional policy measures included putting a date around the timing of the first interest hike. In August 2011, the Fed committed to refrain from raising rates until mid-2013, then shifted to late 2014, and subsequently modified to mid-2015 before moving to its rough target of 6.5% unemployment (which also equates to roughly mid-2015 according to market expectations).

In mid-2011, the yield curve began to steepen notably at one year but that inflection point has been pushed out to three years now due to Fed policy. Although the yield differential between short and intermediate Treasuries is less today, the 3- to 10-year maturity segment remains the steepest portion of the yield curve [Figure 2].

The Fed's commitment to refrain from raising interest rates means there is much less interest rate risk for short-term and some intermediate-term maturity bonds compared to history. The year-to-date changes in Treasury yields reflect this phenomenon [Figure 3]. Treasury yields are higher year-to-date through, March 18, 2013, but the change primarily occurred in long-intermediate to long-term bonds. Thanks to Fed policy, short-term 1- to 3-year yields are essentially unchanged and the rise in bond yields is reflected almost entirely in longer term issues. The change in the 5-year Treasury yield is less than one-third of the 10-year. Short-term yields are likely to remain anchored due to the Fed's commitment and may benefit intermediate maturities as well. Historically, short-term yields responded more to changes to the likelihood of Fed interest rate hikes while longer-term bonds reacted more to changes in economic growth and inflation expectations. This remains the case, but especially so today, as Fed policy implies less interest rate risk and greater stability for short and short-intermediate bonds.

A potential opportunity may exist among high-quality intermediate bonds following year-to-date strength in lower-rated bonds, the rise in high-quality bond yields so far in 2013, and ongoing Fed policy. The primary benefit of a steep yield curve is the added compensation, in terms of yield, for every year an investor extends maturity. The steeper the yield curve, the greater the benefit to extend maturity.

However, a steep yield curve also offers defensive benefits. Over time, a bond will "roll down" the yield curve to a lower yielding maturity and this helps support bond prices. This concept is illustrated in Figure 4 for intermediate Treasuries. Over a one-year time horizon, if interest rates do not change, the total return of the 5-year Treasury, 1.7%, exceeds its current yield to maturity of 0.8% as of March 18, 2013. On the surface, the total returns illustrated in an unchanged interest rate environment may not seem like much, but we believe they stand out in a low-yield world. Such a holding could provide diversification benefits should the economy weaken or demand for high-quality bonds return. A slight decline in interest rates of 0.25%, in the event of safe-haven buying, resulted in meaningfully positive returns. Of course, if interest rates rise by 0.5%, investors suffer a loss, but again this may be an acceptable risk to take in order to potentially offset high-yield bond weakness, for example, after the sector's strong start to 2013.

The 5-year Treasury yield has held in a very narrow range of 0.6–1.2% over the past 18 months thanks in large part to Fed policy. We view the prospects of a rise in interest rates of 0.5% for 5-year bonds as unlikely given the Fed's commitment to keep interest rates low. Therefore, high-quality intermediate bonds may provide a better opportunity for more conservative investors. While the 10-year Treasury also provides an attractive total return if interest rates remain unchanged, the potential loss if interest rates rise by 1.0%, on the high-end of our Bull Case forecast in our *2013 Outlook*, is risk we prefer to avoid. The 10-year Treasury yield has fluctuated in a wider 1.4–2.4% range over the past year and holds greater interest rate risk compared to 4- to 7-year bonds.

The analysis above exemplifies the defensive benefit a steep yield curve provides. The roll down strategy is used by many bond portfolio managers, and roll down is a key reason why we continue to focus on intermediate maturity bonds.

Risks and Opportunities

The recently proposed rescue package for Cyprus is a reminder that ongoing European financial and economic weakness remain a risk for investors and highlights not only the need for a diversified portfolio but also the need to be nimble to help take advantage of opportunities in the bond market. One of the brighter opportunities in the bond market for 2013, high-yield bonds, may be fading as the average yield of high-yield bonds declined to a new record low of 5.6% last week according to the Barclays Index data. Demand may pause as record low yields may restrain additional buying. A prior decline in the average yield of high-yield bonds in January to then record lows was followed by a pullback in high-yield bond prices. In a low-yield world, bond investors have to look harder for investment opportunities and riding the yield curve may provide an opportunity in high-quality bonds. ■

Interest Rate Risk is the risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Such changes usually affect securities inversely and can be reduced by diversifying (investing in fixed-income securities with different durations) or hedging (e.g. through an interest rate swap).

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

A leading economic indicator is an economic indicator that changes before the economy has changed. Examples of leading indicators include production workweek, building permits, unemployment insurance claims, money supply, inventory changes, and stock prices. The Fed watches many of these indicators as it decides what to do about interest rates.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

INDEX DESCRIPTIONS

The Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes Emerging Markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High Yield Index is part of the U.S. Universal and Global High Yield Indices.

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