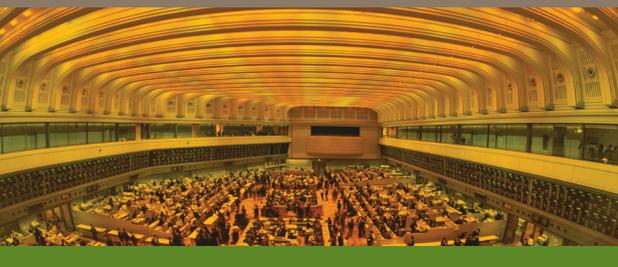


Bond Market Perspectives



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Tapering Tantrums

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Highlights

The fear of an earlier reduction in the pace of bond purchases has been a factor in recent weakness in Treasury prices.

Inflation data argue for continued bond purchases, and focus falls on Fed Chairman Ben Bernanke this week, as he may address this uncertainty.

We continue to view yields as range-bound. Any tapering-related bond sell-off is likely to be limited unless corroborated by better economic data.

This week, bond investors may receive more insight into whether the Federal Reserve (Fed) may begin to taper the pace of bond purchases. Fed Chairman Ben Bernanke's testimony to Congress on Wednesday, May 22, 2013 and the release of the May 1, 2013 Fed meeting minutes on the same day provides a one-two punch of insight as to whether recent market fears may be realized.

Treasury yields continued their recent ascent, on another bout of selling, partially due to fears that the Fed may begin to reduce the pace of bond purchases sooner than expected. The benchmark 10-year Treasury yield flirted with the psychologically important 2% barrier on Monday, May 20, 2013, closing at a 1.96% yield. Also on Monday, Chicago Fed President Charles Evans stated he may support a move to quantitative easing (QE) tapering in coming months should recent labor market improvement continue. His comments were similar to those of San Francisco Fed President John Williams last week, who also suggested recent labor market improvements could warrant a reduction in bond purchases "as early as summer." These comments followed a *Wall Street Journal* article during the prior week by a closely followed Fed watcher, suggesting that the Fed is mulling a reduction in stimulus.

Not So Fast

However, for every Fed official suggesting an earlier end to bond purchases, there are just as many, if not more, who continue to believe a steady dose of bond purchases is warranted. Fed Chairman Ben Bernanke, Vice Chairman Janet Yellen, and New York Fed President William Dudley, the three most influential Fed policy voters, are in this latter group of dovish Fed officials who have spoken in favor of accommodative policy. Last week, Boston Fed President Eric Rosengren expressed concern over weaker inflation and suggested more bond purchases may actually be necessary.

Recent inflation data suggest that the Fed continues to fail on the inflation portion of its dual mandate, and the pace of bond purchases will likely be maintained. Last week's consumer price index (CPI) data revealed that inflation continues to decelerate [Figure 1]. Using the Fed's favorite inflation measure, the core personal consumption expenditures deflator (PCE), inflation remains well below the Fed's 2% objective, running at a 1.1% annualized rate through the end of March 2013.

Forward-looking measures of inflation expectations, such as those implied by Treasury Inflation-Protected Securities (TIPS) prices, reflect a similar

1 Falling Inflation Argues for Continued Bond Purchases



Source: Bureau of Labor Statistics, Bloomberg, LPL Financial 05/20/12
CPI data through 04/30/13

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

2 Market Inflation Expectations Remain Near a Seven-Month Low

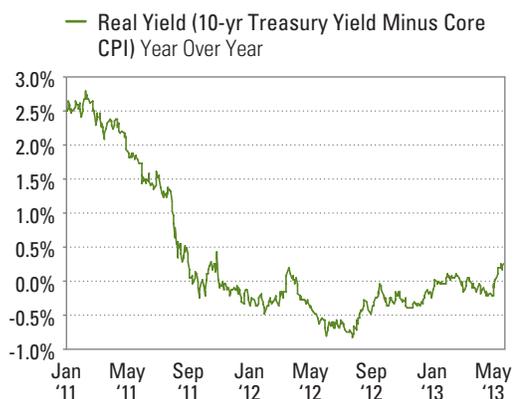


Source: Bloomberg, LPL Financial 05/20/13

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index—while providing a real rate of return guaranteed by the U.S. government.

According to market-based inflation expectations, the Fed may not be doing enough, and bond buying should continue without change.

3 Although Expensive in a Long-Term Context, Treasury Valuations Moved to Their Cheapest Level of the Past Two Years



Source: Bloomberg, LPL Financial 05/21/13

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

story of low inflation and a growing probability of deflation [Figure 2]. According to market-based inflation expectations, the Fed may not be doing enough, and bond buying should continue without change.

The official statement of the May 1, 2013 Fed meeting also appeared to contradict tapering fears. In the official statement, the Fed added a new phrase, “The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes.” By indicating that its already hefty dose of monthly bond purchases may be increased, the Fed contradicted QE tapering fears.

Resolving the Debate

Tapering fears first arose from the minutes of the March 2013 Federal Open Market Committee (FOMC) meeting, released on April 10, 2013, where “some” Fed voting members believed purchases should begin to be tapered by mid-year and finish at year-end. This sentiment appeared to be contradicted by the May FOMC statement but hopefully, Bernanke can clarify the views of his colleagues, and the path of Fed policy, this week.

In the meantime, mortgage-backed securities (MBS) and TIPS, two sectors most sensitive to Fed purchases, have lagged conventional Treasuries. MBS are a key focus of Fed purchases and therefore are directly impacted. TIPS have lagged, since the need for inflation protection is further reduced with the prospect of fewer Fed purchases. From a maturity perspective, long-term bonds, an emphasis of Fed bond purchases, have also lagged during bond market weakness this month.

Keep in mind that following the end of QE1 and QE2, Treasury prices actually increased as investors questioned the durability of the economy without the aid of Fed stimulus. Along with Treasury strength came underperformance of corporate bonds, particularly high-yield bonds. Investors should remember this prior precedent, especially if economic data fail to improve.

As a result of tapering fears, Treasury valuations have reached their most attractive levels of the past two years [Figure 3]. Given that Treasury valuations remain expensive by longer-term comparison, the current level is not overly enticing. Over the past five years, the average real, or inflation-adjusted, 10-year Treasury yield has averaged 1.0% but averaged 2.6% over a longer 20-year history. But extraordinary Fed policy is the main reason why bonds remain so expensive by historical comparison.

For some investors, recent cheapening may be enough to lure in buyers should Fed Chairman Bernanke dispel tapering fears. Conversely, should Bernanke provide clarity on tapering, the upper-end of the Treasury yield range, defined by a 2.06% 10-year Treasury yield (as of March 11, 2013), may be tested once again.

In our view, Bernanke is likely to err on the side of dovish policy, as he has in the past, and any tapering of bond purchases is more likely to occur late in 2013, rather than sooner. Bernanke is also not likely to signal any change



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in timing of first rate increase, which is not expected to occur until 2015. Furthermore, any rise in bond yields will likely have to be corroborated by improving economic data. Recent economic data have often disappointed Bloomberg consensus forecasts, leading us to question the extent of any yield rise. We still expect only a modest increase in yields over the course of 2013*, with yields remaining largely range-bound for much of the year. ■

* Our forecasts are based on a Federal Reserve on hold, the U.S. economic recovery gaining traction, and Treasuries losing their safe-haven premium.

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise, and bonds are subject to availability and change in price.

Bonds given an investment grade rating indicate a relatively low risk of default.

Government bonds and Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax free, but other state and local taxes may apply.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index—while providing a real rate of return guaranteed by the U.S. government.

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.

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