Bond Market Perspectives

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Miserable May

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Highlights

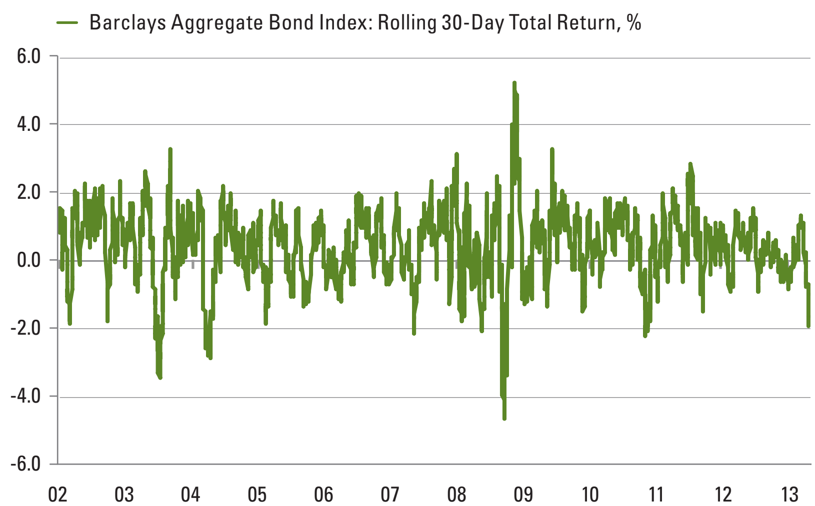
We believe the rise in yields may have run its course, but we remain squarely focused on Friday's employment report as a key catalyst.

History suggests the bond market is poised for stability or a turnaround after one of the worst monthly sell-offs of the past 10 years.

All eyes are on this week's release of the monthly employment report (on Friday, June 7, 2013), as high-quality bonds concluded one of their worst monthly performances of the past 10 years. The broad Barclays Aggregate Bond Index declined 1.8% in May 2013, the worst monthly performance since December 2009, which in turn is the weakest since October 2008. Price declines were broad-based with higher yielding segments of the bond market such as high-yield bonds also suffering price declines. The benchmark 10-year Treasury yield closed sharply higher by 0.5% to close at 2.1%, at the highs of 2013.

Such bouts of bond market weakness over such a short period of time are rare and illustrated in Figure 1. The figure shows the rolling 30-day total return of the broad Barclays Aggregate Bond Index, and the 1.9% May 2013 decline (from May 1 through May 31, 2013) ranks among the sharpest over the past 11 years. Only three times (2003, 2004, and 2008—discussed further below) have declines over such a short period of time been greater. In terms of frequency, monthly declines in excess of 1.5% occurred only 4% of that time period, and recent weakness may have run its course based on history.

1 Sharp Declines Such as Those of May 2013 Are Rare in the Bond Market



Source: Barclays, LPL Financial June 2002 – June 3, 2013

A closer look at prior sharp sell-offs over the past decade shows that bond market returns have stabilized or improved in the subsequent months.

2 Bond Market Returns Following a 1.5% Pullback During a Given Month

	Loss During Month of Pullback	Bond Performance in Subsequent Months		
		+1	+2	+ 3
December 2009	-1.6	1.5	0.4	-0.1
October 2008	-2.4	3.3	3.7	-0.9
April 2004	-2.6	-0.4	0.6	1.0
July 2003	-3.4	0.7	2.7	-0.9

Source: Barclays Aggregate Bond Index data, LPL Financial May 2003–May 2013

Figure 1 also illustrates how such weakness typically reverses quickly as returns subsequently improve. A closer look at prior sharp sell-offs over the past decade shows that bond market returns have stabilized or improved in the subsequent months [Figure 2].

Prior Sell-Offs

A look back at these prior sell-offs reveals limited similarities. In December 2009, economic growth expectations in response to the Federal Reserve's (Fed) quantitative easing 1 (QE1) began to increase and pushed yields higher only before bond prices rose again, and yields declined, as growth in early 2010 failed to meet expectations. Volatility in response to the financial crisis pushed prices lower in October 2008, and April 2004 witnessed declines as a result of Fed rate hike fears, a situation not prevalent today. Mortgage-backed securities (MBS) volatility drove the July 2003 sell-off, and some characteristics are evident in the May 2013 pullback.

MBS underperformed Treasuries in May 2013 with the average yield of recently issued, or "current coupon," rising by 0.65% during the month, more than the 0.5% rise of the 10-year Treasury yields. As MBS underperform, investment managers often sell Treasuries to hedge price declines. Since the MBS market comprises 29% of the benchmark Barclays Aggregate Bond Index, the impact can be profound. Although we do not expect hedging to reach 2003 magnitudes, it has been a factor in recent selling.

Near-Term Direction

Despite history, we still believe this week's employment report will be a key catalyst for the bond market's near-term direction. The Fed's extraordinary measures of the past few years put the bond market in unchartered waters, and future reactions may not follow historical norms. The Fed now appears more focused on labor market strength rather than benign inflation, and a strong report may exacerbate fears that the Fed may slow the pace of bond purchases soon with the 10-year Treasury yield perhaps testing 2.4%, the upper-end of the longer-term yield range [Figure 3].

Conversely, a weaker-than-expected report may help the bond market stabilize and may even spark a rally as investors take advantage of cheaper

3 A Strong Employment Report May Stoke More Fed "Tapering" Fears with Treasury Yields Testing the 2.4% High of the Longer-Term Range

Source: Bloomberg, LPL Financial 06/03/13

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valuations. As we mentioned in last week's commentary, bond market expectations have quickly moved to expect the Fed to begin to reduce, or taper, bond purchases in September 2013, up from a prior consensus of December 2013. A weak or merely consensus employment report would likely reinforce the now-consensus expectation of the Fed beginning to slow the pace of bond purchases in September 2013.

We believe the rise in yields may have run its course, but we remain squarely focused on Friday's employment report, as it contains clues to the Fed's next move. Again, a stronger-than-expected report may keep alive fears that the Fed could reduce bond purchases as soon as late June or even in July, an outcome we place a low probability of occurring, but one that could send bond prices lower still. In the event prices do fall lower, the bond market may quickly adjust, providing an opportunity after a June swoon or July dive as yields adjust to a new reality. On the other hand, a disappointing employment report would mean now is the time for investors to take advantage of higher yields after a miserable May amid what is still likely to be a low-return environment. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

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.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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.

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.

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.

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.

This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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.

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