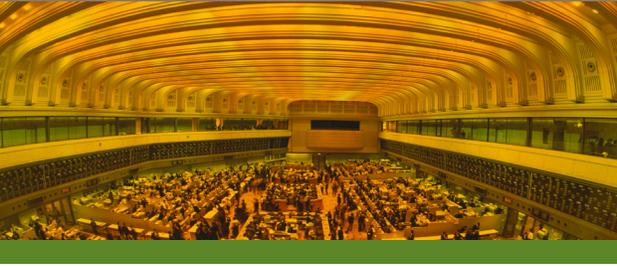


Bond Market Perspectives

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Highlights

Foreign demand for U.S. bonds has been weak in 2013 and played a role in the recent bond market weakness.

The yield differential between U.S. and German government bonds and recent auction results suggest that foreign demand for Treasuries and U.S. bonds may be improving.

The return of foreign buying of U.S. bonds may further support our expectation of a range-bound bond market.

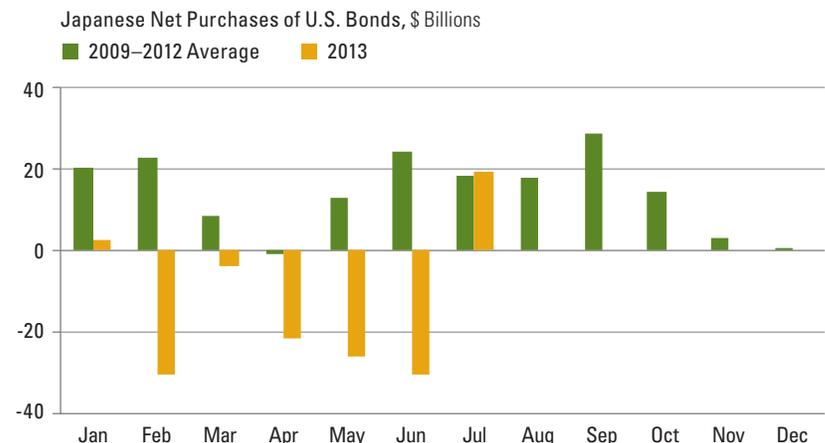
Foreign Buying Intrigue

Like an international mystery caper, the habits of foreign bond buyers are not always readily apparent. Data on foreign buying are available from a few sources but with a lag, leaving investors to piece together the details over time. Any “real-time” information is only anecdotal via trading desks and therefore very difficult to quantify. Over recent weeks it has become clear that foreign investors’ apathy toward U.S. bonds played a role in the recent bond market sell-off. Foreign buying habits can play a significant role in the bond market and are closely watched since foreigners still own nearly half of outstanding marketable U.S. Treasury debt.

This week’s release of Treasury International Capital System (TICS) data may reveal that foreign investors were sellers of U.S. bonds once again this past June. The news will not come as a big surprise based upon earlier reports that indicate foreigners, on balance, have been sellers of U.S. Treasuries so far in 2013. According to TICS data, foreigners sold a net \$49 billion of U.S. Treasuries in March and April of 2013. Buying resumed in May but on a year-to-date basis, foreigners have been net sellers of Treasuries in 2013, resulting in the weakest foreign demand since 2000.

Japan, the second-largest holder of U.S. Treasuries, was perhaps the most notable seller of U.S. bonds. Japan has typically been a buyer but was a significant seller in April, May, and June [Figure 1], a period of time that overlapped with a severe bond market sell-off. Japanese investors were not

1 Japanese Investors Led Recent Foreign Selling of U.S. Bonds

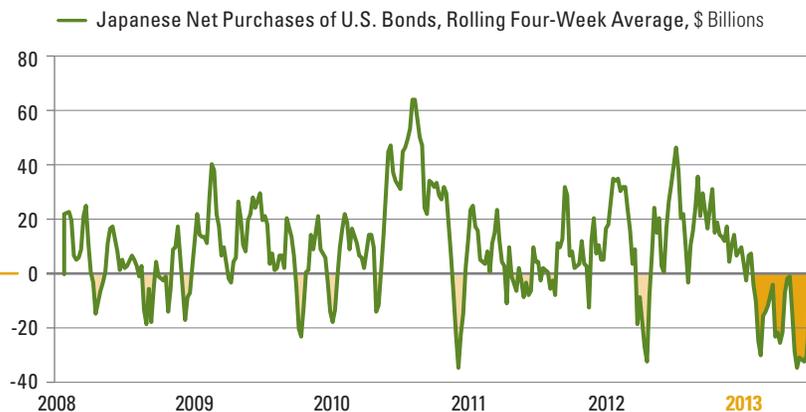


Source: Bloomberg, Japan Ministry of Finance, LPL Financial 07/31/13



2 2013 Has Witnessed the Longest Sustained Selling by Japanese Investors Since the End of the Recession

Japan has been a **consistent seller** this year in contrast to prior bouts of short-lived selling.



Source: Bloomberg, Japan Ministry of Finance, LPL Financial 07/31/13

only notable sellers of U.S. bonds to the tune of \$20–\$30 billion per month over that period but also have deviated dramatically from their typical buying habits exhibited since the end of the financial crisis. In fact, Japan has been a consistent seller this year [Figure 2] in contrast to prior bouts of selling, which were short lived.

The Bank of Japan's aggressive monetary stimulus was the catalyst for recent selling. Investors anticipated the Bank of Japan's actions to stimulate buying of foreign bonds at the expense of Japanese government bonds but the opposite occurred as Japanese investors took profits on foreign bonds. Nonetheless, Japanese bond investors may still look to take advantage of higher overseas yields. Buying resumed in July and helps explain bond market stability over the month.

Foreign selling or buying of U.S. bonds is just one of several factors that can influence bond prices and yields. In 2011 and 2012, foreigners were net sellers of corporate bonds yet corporate bonds were one of the better performing domestic bond sectors according to Barclays Index data over the period. From mid-2004 through mid-2008, Japan was a gradual seller of Treasuries yet Treasury yields were largely range-bound before prices rose and yields declined in 2007 and 2008. The impact of foreign selling can be more than offset by other factors such as Federal Reserve (Fed) policy, inflation, and the pace of economic growth, each of which can have a greater influence on bond prices higher or lower.

As a side note, China, the largest holder of U.S. Treasuries has been a steady buyer in 2013 and increased Treasury holdings by nearly \$100 billion through the end of May. China's Treasury purchases are a by-product of its export-led economy. China's reserves are often invested in Treasuries and also used as a tool to slow appreciation of its currency. China's purchases show that many factors drive foreign buying habits and that a broad-based retrenchment of foreign bond buying of U.S. bonds is unlikely.



Domino Effect

In 2013, diminished foreign buying of Treasuries coincided with the Fed's intent to reduce, or taper, the pace of bond purchases. With foreigners already showing lackluster interest, the prospect of fewer purchases by the Fed, the biggest buyer of Treasuries, caused alarm and subsequent selling in the bond market. In addition, TICS data also reveal that Cayman Island domiciled investors, typically comprised of hedge funds and leveraged investors and not necessarily "foreign," sold over \$30 billion worth of Treasuries in May alone. Treasuries are the backbone of the bond market and as weakness spread, ripples were felt across fixed income markets. While not solely responsible for the recent bond market sell-off, the lack of foreign purchases of U.S. bonds has been a negative for fixed income markets.

Mind the Gap

The yield differential between U.S. and German government bonds suggests that foreign demand for Treasuries may be improving. The yield gap between 10-year Treasuries and 10-year German Bunds reached 1.0% in July, the high-end of a 10-year range [Figure 3]. The greater the yield gap the more attractive Treasuries are relative to German Bunds and vice versa. Stronger economic growth in the United States compared to Germany and broader Europe suggests longer-term Treasury yields should be higher compared to their German counterparts. However, in an environment of low yields globally, the extra 1.0% yield advantage of Treasuries stands out. The yield differential between 10-year Treasuries and Bunds has contracted slightly since it peaked at just over 1% in mid-July suggesting foreign investors are finding value in the now higher level of U.S. government bond yields.

The most recent time the yield differential was near 1.0% occurred in April 2010, ironically the last time a notable period of bond market weakness came to a close. From early October 2010 through early April 2011, high-

3 The Yield Advantage of Treasuries Relative to German Bunds is Near a 10-Year High



Source: Bloomberg, LPL Financial 08/12/13

In an environment of low yields globally, the extra 1.0% yield advantage of Treasuries over German Bunds stands out.



quality bond prices declined and the 10-year Treasury yield increased by 1.2% in a sell-off similar in magnitude to the recent bond pullback.

Auction Clues

Auction trends also suggest that foreigners are returning to the U.S. bond market. Last week's sale of 3-, 10-, and 30-year Treasuries witnessed indirect bidders, a group that includes foreign central banks that place purchases "indirectly" through the Federal Reserve Bank of New York instead of a primary dealer of Treasuries, win a high percentage of each auction continuing a trend that began in July.

Recent data suggest foreign investors have begun to return to the U.S. bond market, a factor that bodes well for additional bond market consolidation.

Successful investing often requires being a good detective. Sleuthing together details on foreign purchases of U.S. bonds reveals that foreigners played a role in the recent bond market sell-off. Foreign selling combined with the Fed's intent to reduce bond purchases produced a powerful one-two punch to the bond market. However, recent data suggest foreign investors have begun to return to the U.S. bond market, a factor that bodes well for additional bond market consolidation. The prospect of fewer Fed bond purchases means that the any increase in bond prices is likely to be limited but a resumption of foreign purchases of U.S. bonds is another factor that may help support a range-bound yield environment. ■

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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.

Investing in foreign securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with varying accounting standards.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

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