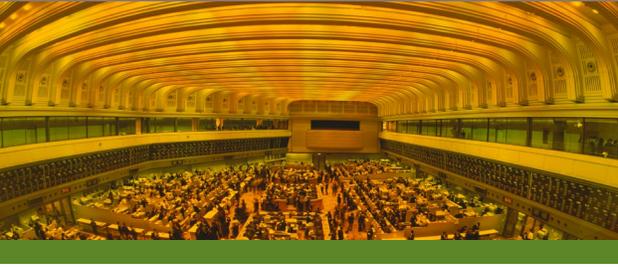


# Bond Market Perspectives



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## The Yield Ascent Resumes

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#### Highlights

Rising economic growth expectations, not Fed “tapering” fears, fueled the most recent leg down in the bond market.

Bond weakness may linger until more specifics about Fed tapering the pace of bond purchases becomes available.

Most recent weakness was driven by both economic growth expectations and subsequent longer-term rate hike expectations.

The bond market sell-off entered a new phase last week as Treasury yields broke clear to new highs. Intermediate- to long-term Treasury yields rose by 0.21% to 0.25% with the benchmark 10-year Treasury yield closing the week at a 2.83% yield, surpassing the July 5, 2013 peak of 2.74%. Weakness continued to start the current week as the 10-year Treasury rose further to 2.89% as of Monday, August 19, 2013. The break above the 2.75% yield level puts a 3.0% 10-year Treasury yield as the next possible objective.

Unlike the initial leg of bond market weakness, which was driven equally by better economic growth expectations, Federal Reserve (Fed) rate hike fears, and concerns over a reduction in Fed bond purchases, most recent weakness was driven by both economic growth expectations and subsequent longer-term rate hike expectations. Better economic growth expectations are evident by a steeper yield curve [Figure 1]. The greater the yield differential between short- and longer-term bond yields, the “steeper” the yield curve, and vice versa. Higher long-term yields reflect the added compensation, in terms of yield, investors require to tolerate longer-term inflation risks brought on by an expanding economy.

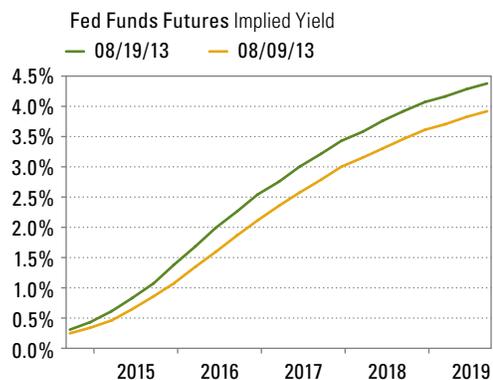
#### 1 The Yield Curve Steepened on Improving Growth Expectations



Source: Bloomberg, LPL Financial 08/19/2013

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

## 2 Markets Moved to Price in More Rate Hikes Once the Fed Begins in 2015



Source: Bloomberg, LPL Financial 08/19/2013

Recent bond price movements suggest that economic growth is strong enough to warrant a faster pace of interest rate hikes once the Fed decides to raise interest rates.

A federal funds futures contract is a futures contract for the simple average of the daily effective federal funds rate during the month of the contract. Contracts range from the current month to 24 months out. The effective federal funds rate is a weighted average of all federal funds transactions for a group of federal funds brokers who report to the Federal Reserve Bank of New York each day.

Higher long-term yields also reflect the prospect for more Fed interest rate hikes in the future. Last week's sell-off also reflected the bond market moving to anticipate a more rapid pace of Fed rate increases once the Fed begins to increase interest rates in 2015. Although shorter-dated Fed fund futures moved to reflect a modest increase in the possibility the Fed may increase interest rates sooner than the mid-2015 guidance, the greater move occurred among longer-dated futures [Figure 2]. As of Monday August 19, 2013 pricing, a return to a 4.0% target Fed funds rate is now anticipated by June 2018, a full year earlier than a June 2019 expectation as recently as 10 days prior on August 9, 2013.

Interestingly, short-term Fed rate hike expectations were little changed, and the odds of an earlier start to initiating interest rate increases, such as early 2015 or even late 2014, were only slightly higher over the prior week. According to Fed fund futures, the probability of a second 0.25% rate increase occurring by June 2015 rose to 20% last week but still below the 100% likelihood priced in on July 5, 2013. Fed Chairman Ben Bernanke's public comments in July appear to have stemmed fears about an earlier start to Fed rate hikes. Furthermore, recent bond price movements suggest that economic growth is strong enough to warrant a faster pace of interest rate hikes once the Fed decides to raise interest rates.

We do not view current Fed interest rate hikes implied by market pricing as excessive. Fed fund futures pricing remains less aggressive than early July levels. Therefore, we do not necessarily view recent weakness as a mispricing subject to quick correction. Market weakness may persist over the coming weeks due to lingering uncertainty over exactly how the Fed may go about "tapering" bond purchases.

Upward pressure on yields may also linger in the absence of top-tier economic data and light summer trading volume, which may exacerbate recent weakness. With a light data calendar, the release of the Federal Open Market Committee (FOMC) minutes may be the focal point for the bond market this week and may provide some insight as to how, and by how much, the Fed may reduce bond purchases. The Fed's annual Jackson Hole conference, a prior market-moving event in the past, will begin this weekend but the absence of Fed Chairman Bernanke will likely diminish the odds of any potential impact for the subsequent week.

In contrast to Fed fears, bonds may receive a boost from safe-haven buying should recent equity market weakness persist (the S&P 500 declined just over 2% the prior week). Although stock and bond prices declined in unison last week, additional equity weakness may boost investor interest in bonds. Nevertheless, the break to still-higher bond yields warrants a defensive posture until bond yields show signs of stability. ■



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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.

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.

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.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of U.S. Treasury securities).

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 a fund shares is not guaranteed and will fluctuate.

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#### INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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