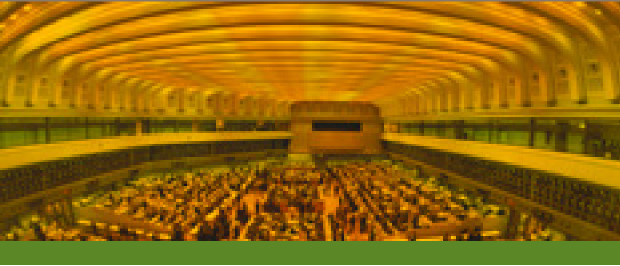
Bond Market Perspectives



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The Bond Sell-Off in Perspective

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Highlights

The recent bond market pullback ranks among the worst of the past 20 years, but investors have seen this before.

Bond sell-offs that last more than a few months have been pushed by Fed rate hikes, something that is not on the near-term horizon.

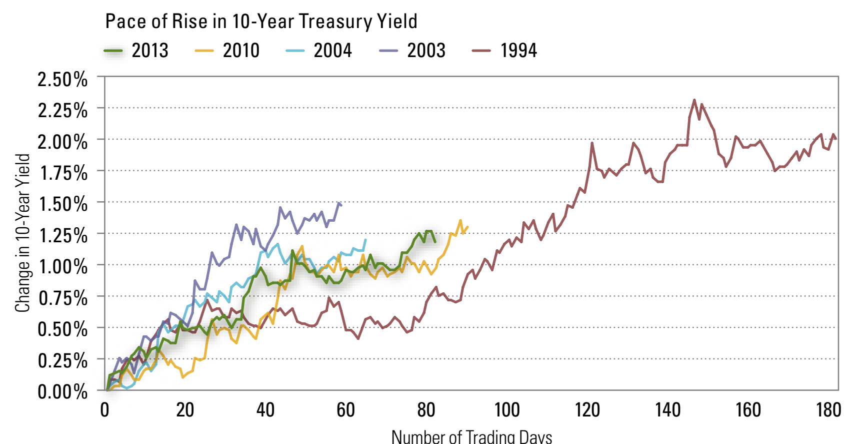
A flatter yield curve and aggressive Fed rate hike expectations are two factors suggesting that recent bond market weakness may subside in coming weeks.

Longer-term Treasury yields finished last week roughly unchanged, but that is little consolation to investors during a difficult month of August. Investor patience was tested once again with a volatile week that saw the benchmark 10-year Treasury yield rise as high as 2.89% before creeping lower late in the week. For the month of August, however, the high-quality bond market, as measured by the broad Barclays Capital U.S. Aggregate Bond Index, is on track to close lower as weakness persists.

The recent bond market pullback ranks among the worst of the past 20 years, but investors have seen this before. The rise in Treasury yields has been similar to other periods of rapidly rising interest rates [Figure 1]. Figure 1 illustrates how much and for how long interest rates rose before rates subsequently began to steadily fall with the lone exceptions of 1994, which lasted 14 months (and not fully shown in the figure to help with scale), and the current period, which may not be over. Since yields bottomed on May 2, 2013, the 10-year Treasury yield has increased by roughly 1.25 percentage points. The current pullback is tracking very similarly to the 2010 episode that was also spurred by expectations of stronger economic growth. The current rise in bond yields is also approaching the length of the 2010 experience and already surpassed the duration of the 2003 and 2004 pullbacks.

The rise in Treasury yields has been similar to other periods of rapidly rising interest rates.

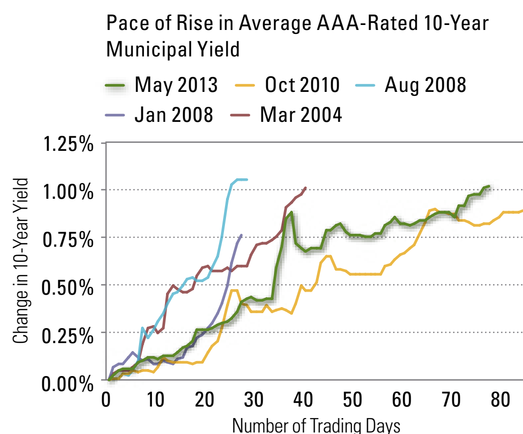
1 Comparing the Pace of the 10-Year Treasury Yield Increase



Source: Bloomberg, LPL Financial 08/26/13

Past performance is no guarantee of future results.

2 Comparing the Rise in Municipal Bond Yields



Source: Bloomberg, LPL Financial 08/26/13

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong. Past performance is no guarantee of future results.

A look at the municipal bond market reveals both a sharp and extended rise in yields [Figure 2]. The overall increase in yields is not only similar to the magnitude of 2004 and 2008 but also as lengthy as the late 2010–2011 sell-off.

Although we cannot say that the current pullback is over, using last week's 2.9% peak in the 10-year Treasury yield on Wednesday, August 21, 2013 reveals the current sell-off ranks among the worst of the past 20 years in terms of total return [Figure 3]. The 4.4% decline in the Barclays Capital U.S. Aggregate Bond Index from May 2, 2013 through August 21, 2013 (shown in the final row of Figure 3), is more than double the 2.1% average bond bear market sell-off.

The shaded areas of Figure 3 highlight the longest bond bear markets, each of which lasted over one year. However, each of those periods has one thing in common: Federal Reserve (Fed) rate interest rate hikes, something that is unlikely in the near future. We believe the Fed will wait until 2015 before raising short-term interest rates. Figures 1 and 2 illustrate that current bond weakness, both taxable and municipal bonds, has become extended relative to other periods of bond weakness that did not involve Fed rate hikes. Therefore, we believe bond weakness may be close to an end.

3 The Current Sell-Off Ranks Among the Worst of the Past 20 Years

Rising Rates Start Date	Rising Rates End Date	Length (Months)	10-Year Treasury Yield Change	Broad Bond Market Return*	Sector Performance^				
					Treasury	MBS	Corporate	High-Yield	Municipal
9/30/93	11/30/94	14	2.5	-3.5%	-4.3%	-1.5%	-4.9%	2.0%	-5.9%
1/31/96	8/30/96	7	1.4	-1.8%	-2.4%	0.0%	-2.9%	3.2%	-0.3%
11/29/96	3/31/97	4	0.9	-1.5%	-1.9%	-0.4%	-2.4%	1.8%	-0.7%
10/5/98	1/21/00	16	2.6	-2.3%	-4.5%	1.5%	-3.8%	3.7%	-2.6%
11/7/01	4/1/02	5	1.2	-2.4%	-4.8%	-0.5%	-2.8%	4.7%	-1.5%
6/13/03	9/3/03	3	1.5	-4.5%	-6.5%	-1.7%	-6.0%	1.1%	-4.5%
3/16/04	6/14/04	3	1.2	-4.3%	-5.2%	-3.0%	-5.4%	-1.9%	-4.6%
6/1/05	6/28/06	13	1.4	-1.3%	-2.2%	-0.1%	-2.7%	5.5%	1.0%
3/5/07	6/12/07	3	0.8	-1.8%	-2.0%	-1.4%	-2.9%	1.6%	-1.8%
3/17/08	6/16/08	3	1.0	-2.2%	-4.5%	-2.3%	-1.1%	6.2%	1.0%
12/30/08	6/10/09	5	1.9	-0.5%	-7.0%	1.5%	4.7%	32.2%	6.2%
11/30/09	4/5/10	4	0.8	-0.5%	-2.3%	-0.6%	0.8%	8.3%	1.6%
10/8/10	2/8/11	4	1.3	-3.1%	-4.7%	-1.7%	-3.4%	5.0%	-5.5%
9/22/11	10/27/11	1	0.7	-1.7%	-2.8%	-1.1%	-1.1%	3.7%	-1.2%
1/31/12	3/19/12	2	0.6	-1.2%	-2.5%	-0.2%	-0.9%	2.3%	-1.0%
7/24/12	9/14/12	2	0.5	-0.7%	-1.8%	0.2%	-0.5%	4.0%	-0.4%
12/6/12	3/11/13	3	0.5	-1.0%	-1.5%	-0.3%	-1.2%	3.2%	-1.1%
5/2/13	**8/21/13**	**4**	**1.3**	**-4.4%**	**-4.0%**	**-3.5%**	**-6.3%**	**-2.6%**	**-6.2%**
Average		**5**	**1.2**	**-2.1%**	**-3.6%**	**-0.8%**	**-2.4%**	**4.7%**	**-1.5%**

Source: Barclays Index data, LPL Financial 8/26/13

Shaded areas coincide with periods of Federal Reserve interest rate hikes.

* Barclays Capital U.S. Aggregate Bond Index; ^ Asset Class Indexes: High-Yield – Barclays US High Yield Corporate Index; Mortgage-Backed Securities (MBS) – Barclays US MBS Index; Treasury – Barclays US Treasury Index; Municipal – Barclays Municipal Bond Index.

The fed funds rate is the interest rate on loans by the Fed to banks to meet their reserve requirements.

4 The Yield Curve Flattened Notably Last Week

Source: Bloomberg, LPL Financial 08/26/13

Note: A rising line indicates a steeper yield curve as yield differential between 5- and 10-year bonds has increased. A falling line indicates a "flatter" yield curve as the yield differential between 10- and 5-year Treasuries narrowed.

The bond market has already gone a long way to price in greater economic growth and a more aggressive Fed.

Two additional factors point to a potential near-term inflection point for bonds:

Aggressive Fed rate hike expectations. As of last Friday, August 23, 2013, fed fund futures, one of the better measures of market expectations of future Fed rate increases, indicated a 52% probability of a Fed rate hike by the fourth quarter of 2014. In sum, the market placed a significant probability of interest rate increases starting earlier than mid-2015, the Fed's guidance for an expected first interest rate increase. We believe 2014 rate hike expectations are overly aggressive given the sluggish pace of economic growth and still-low inflation. The last time Fed rate hike expectations were so aggressive was July 5, 2013, when the 10-year Treasury yield reached 2.74%, not far from today's levels. The bond market appears to have built in a buffer in case new leadership at the Fed (current Fed Chairman Bernanke's term ends on January 31, 2014) begins to raise interest rates sooner than stated and "tapering" of bond purchases is completed over a shorter time frame.

A flatter yield curve. The yield differential between 5- and 10-year Treasuries narrowed sharply last week [Figure 4]. We use the 5-year, rather than the 2-year, as a starting point as it is less influenced by the Fed's commitment to keep rates pegged near zero until 2015 and therefore more influenced by market forces. The larger the yield differential between short and intermediate Treasuries the more upward sloping, or "steep," the yield curve is and vice versa. A steep yield curve usually reflects stronger economic growth expectations as investors anticipate higher future interest rates and also require higher yields as compensation for taking on added interest rate risk. Conversely, a flatter yield curve is indicative of the bond market anticipating slower economic growth and investors requiring less yield compensation on longer-term bonds. The flatter shape of the yield curve last week suggests bond investors believe the rise in yields may be sufficient and may work to slow economic growth.

The yield curve flattened in a similar fashion in early June of this year so by itself does not signal the end of bond market weakness. However, in conjunction with more aggressive Fed rate hike expectations, the two indicators suggest the bond market has already gone a long way to price in greater economic growth and a more aggressive Fed.

Furthermore, the current bond market pullback is becoming extended when compared to prior episodes that were not accompanied by Fed interest rate hikes. The absence of Fed rate hikes in coming months is another factor suggesting that an additional catalyst, such as still-stronger economic data, or a greater-than-anticipated reduction in bond purchases at the upcoming September 17–18 Fed meeting, may be necessary to prolong high-quality bond weakness. In the absence of both, and given that economic data have turned more mixed as of late, we find high-quality bonds fairly valued. Any potential upside is likely limited in the near term due to next week's jobs report, but more signs are pointing to the bond pullback gradually ending and this difficult period for bond investors may pass. ■

IMPORTANT DISCLOSURES

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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.

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.

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.

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

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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.

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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 Capital U.S. 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 Capital U.S. Aggregate Bond Index is an unmanaged index and cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

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.

Barclays Capital U.S. MBS Index measures the performance of investment-grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA, and FHLMC.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

The Barclays Treasury index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include t-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

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