Bond Market Perspectives

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History Repeating

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Highlights

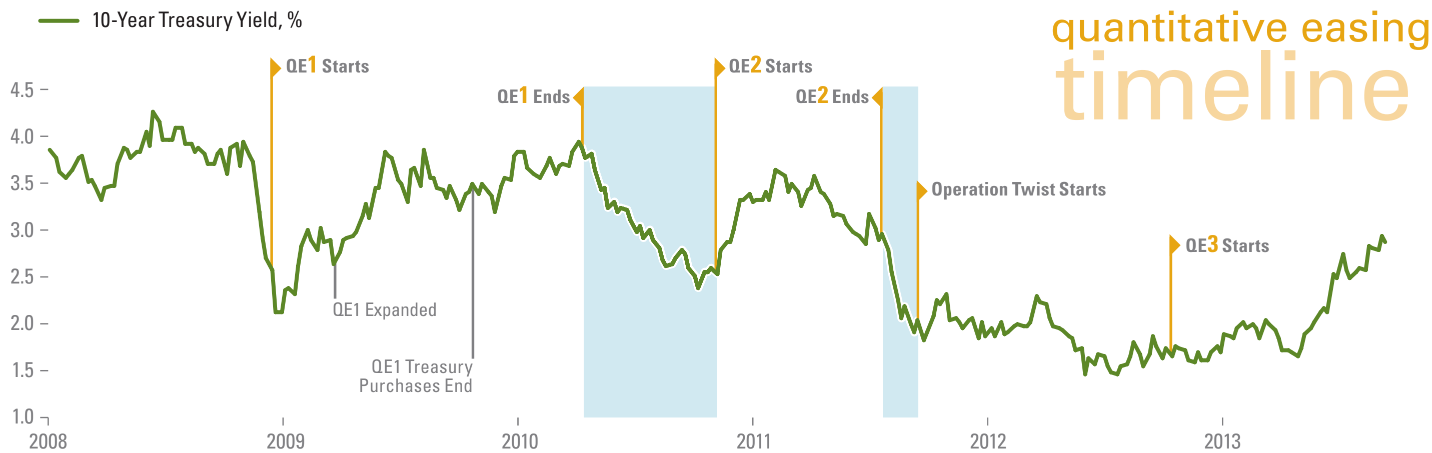
The Fed's expected announcement of a reduction in bond purchases may result in lower yields if history is any guide.

Any decline is likely to be limited this time given reasonable expectations of long-term Fed interest rate increases.

Treasury yields declined heading into this week's Federal Reserve (Fed) meeting, where the Fed is expected to announce a reduction, or tapering, of bond purchases. Even with looming uncertainty from the Fed meeting outcome, bonds witnessed robust investor demand last week with all three Treasury auctions, including more interest rate sensitive 10- and 30-year securities, witnessing strong demand. Investment-grade corporate bonds were also the beneficiary of strong demand as a record investment-grade corporate bond sale was upsized to nearly three times the prior record sale.

Bond market gains ahead of a pivotal Fed meeting raise the question of whether bonds will follow the same path as the end of prior Fed bond-purchase programs such as QE1 and QE2 (quantitative easing). Bond prices rose and yields fell the last two times the Fed pulled back stimulus [Figure 1]. However, the Fed will still be purchasing bonds after this week's meeting, which is a key difference from the end of QE1 and QE2, when the Fed stopped bond purchases completely. Therefore, the Fed will still be providing stimulus to financial markets and the economy albeit at a reduced pace. In the past, a reduction of bond purchases was viewed as a threat to

1 Bond Prices Rose and Yields Declined the Last Two Times the Fed Ended Bond Purchases



Source: Bloomberg, Federal Reserve, LPL Financial 09/13/13

Past performance is no guarantee of future results.

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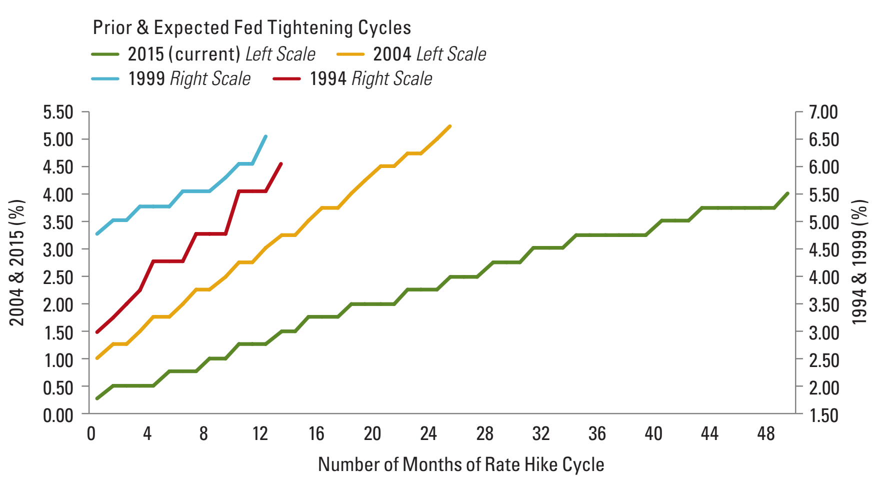
the economy and bond yields declined, but we believe the current economy is more self-sustaining even if growth is sluggish.

The news that former Treasury Secretary Larry Summers withdrew his name for consideration as the next Fed Chairman continued the positive bond momentum as the current week began. Summers, who had been considered the front-runner to lead the Fed when Ben Bernanke's term ends in January 2014, was viewed as more likely to end easy Fed policy earlier and perhaps begin to raise interest rates sooner than the current Fed guidance of mid-2015. Bond market fears of an earlier-than-expected start to interest rate hikes were allayed upon his withdrawal and bond prices rose in response.

This week's Fed meeting may produce two additional positive catalysts for bonds:

- **Thresholds and interest rate guidance.** The Fed may announce a lower bound on inflation of 2%, for example, below which the Fed will commit to not raise interest rates. Additionally, or alternatively, the Fed may lower its unemployment target to 6% from 6.5% as the point at which it begins to consider raising interest rates. Both moves would likely signal a later start to interest rate hikes and bond prices may rise and yields fall on the more benign interest rate view. Furthermore, the Fed may continue to stress that interest rate hikes are a long way off despite the onset of tapering, in an attempt to keep interest rates low.
- **2016 forecasts.** This week's Fed meeting will be the first where the Fed presents its 2016 economic forecasts. Included in the forecasts are expectations about where Fed officials believe the benchmark fed funds target rate will be at the end of 2016. Their forecasts may provide a

2 Current Fed Rate Hike Expectations Are More Gradual Than Historical Precedent



Source: Bloomberg, CBOT, LPL Financial 09/16/13

Note: Chart shows change in the target fed funds rate historically and what is currently implied by fed fund futures, which show a 2015 start to interest rate increases with a gradual progression to a 4% fed funds rate over a 49-month time frame.

guidepost to future interest rate hikes. Futures pricing currently indicates an approximate 2.25% year-end 2016 fed funds target rate. A lower forecast at the conclusion of the Fed meeting may spark a bond rally as existing rate hike expectations may prove too aggressive, while a higher forecast may catch the market off-guard and signal the Fed will bring interest rates back up to a more normal level more quickly.

We believe futures pricing for 2016 appears fair and would require a fairly hawkish forecast from the Fed to spark additional weakness.

We place a low probability of new thresholds occurring at this week's Fed meeting, but the 2016 forecasts could be impactful. As we have mentioned in prior commentaries, the recent bond market sell-off has gone a long way to factor in a more aggressive path of Fed policy over coming years. Fed officials' forecasts of the year-end 2016 fed funds rate could determine whether the rise in bond yields has gone far enough and whether still higher, or perhaps lower, yields are warranted based upon their views. We believe futures pricing for 2016 appears fair and would require a fairly hawkish forecast from the Fed to spark additional weakness.

We see a potential bond market rally in response to a more bond-friendly Fed as limited, however. Futures indicate a slow and gradual approach to Fed interest rate hikes [Figure 2]. The current expectation of a slow approach contrasts with the more rapid, and greater magnitude, rate hikes in prior cycles of Fed rate increases. Therefore, market expectations about Fed interest rate hikes are not excessive even after substantially increasing in recent months.

Interest income, the main driver of fixed income performance over time, coupled with stable prices could help foster positive returns from bonds over the remaining months of 2013.

Still, even stabilization would be welcomed by bond investors, something that we see as increasingly likely after more than four months of bond price declines to better account for a gradual reduction of Fed accommodation. On balance, the potential for a change in thresholds or benign 2016 rate guidance skews the outcome for bonds more positively, in a repeat of history, but a more aggressive Fed message, which we view as less likely, could spark renewed selling. Should the Fed follow the widely anticipated script this week, bond prices may see little change. Interest income, the main driver of fixed income performance over time, coupled with stable prices could help foster positive returns from bonds over the remaining months of 2013. ■

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.

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.

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.

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.

Federal funds rate is the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight.

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.

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