Bond Market Perspectives

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Summer Fling

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Highlights

The best week of bond market performance since mid-July 2013 may be nothing more than a summer fling.

Gains are likely limited due to lingering uncertainty over a reduction in Fed bond purchases, but at the same time the recent rise in rates indicates the bond market has already gone a long way to anticipate a change in Fed policy.

The Labor Day weekend marks the unofficial end of summer and for bond investors it ended with sunny skies with the best week of performance since mid-July. The broad Barclays Aggregate Bond Index returned 0.4% last week, the best weekly gain since a 0.7% return the week ending July 19, 2013, to finish a difficult month of August on a positive note. Is this the start of a more meaningful long-term relationship for bond investors after a tumultuous summer or just a summer fling that will prove short-lived? The answer may not become apparent until the end of this week with the release of the monthly employment report.

Both short-term and long-term factors influenced the bond market last week. Short-term influences included:

- **Safe-haven bond buying.** Fears of escalating geopolitical risks in Syria helped boost demand for bonds. High-quality bonds benefited as investors sought less volatile assets ahead of the long holiday weekend.
- **Bond index extension.** The average duration of widely followed bond indexes such as the Barclays Aggregate Bond Index increased in August and prompted buying of intermediate- and longer-term bonds from passive investors who seek to closely replicate the characteristics of the widely followed bond benchmark.

Longer-term influences included:

- **Mixed economic data.** Weekly jobless claims were little changed but disappointing data on business investment and personal income sparked downward revisions to forecasts for third quarter economic growth, according to Bloomberg. Additionally, the Federal Reserve's (Fed) preferred measure of inflation rose at an annualized rate of only 1.2%, still near the slowest pace of the past two years and raised questions as to whether the Fed may actually follow through with a reduction of bond purchases.
- **Lukewarm Treasury auction demand.** Among last week's auctions of 2-, 5-, and 7-year Treasury notes, only the 2-year note witnessed strong demand. Demand for 5-year Treasuries was on the soft side, while 7-year auction demand was average. Auction results continued to show improved demand from weak results in June but were still well short of robust. Although the auctions occurred amid light summer trading, the results continue to suggest caution on the part of bond investors. Greater demand will be needed to bring about a more lasting bond market improvement.

This Friday's (September 6, 2013) release of the monthly employment report will be the last important piece of data to potentially sway the Fed

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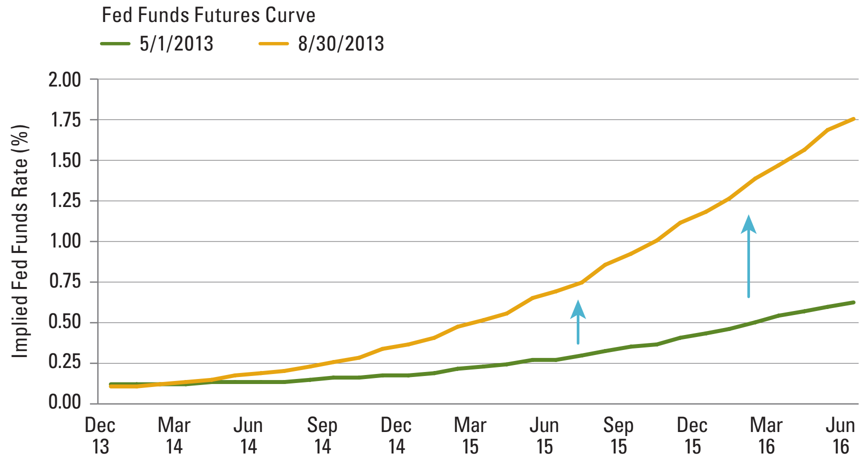
1 The Bond Market Has Already Priced in a More Aggressive Fed



Source: CBOT, Bloomberg, LPL Financial 08/30/13

on whether to taper bond purchases—and, if so, by what amount—at the conclusion of its September 17–18, 2013 meeting. A strong report may spark another round of tapering fears and push Treasury yields back to recent highs and prices lower. Conversely, a weak report would add to recent concerns about an economic slowdown and/or boost expectations the Fed may delay tapering.

In our view, recent data are not weak enough to derail the Fed from tapering bond purchases at the conclusion of its upcoming meeting. However, the bond market has gone a long way to anticipate Fed uncertainty and already priced in a more aggressive path of Fed interest rate hikes [Figure 1]. As mentioned in last week's commentary (*The Bond Sell-Off in Perspective*), the bond sell-off has become extended. A protracted sell-off has historically required active Fed rate increases, something that is not likely until 2015.

Still we see bond strength as limited over the very near term. The Fed has made its intention to taper bond purchases clear and Friday's employment report may not change their minds. Given the uncertainty over the timing and the dollar amount reduction to bond purchases, price gains in bonds are likely limited over the near term.

The bond market has already priced in a substantial amount of Fed rate hikes and therefore begun the process of bracing for higher future short-term interest rates.

So we caution against reading into last week's summer fling in the bond market, but investors should also not get too pessimistic. The Fed's announcement of a reduction in bond purchases may not result in significant further sell-off. As illustrated in Figure 1, the bond market has already priced in a substantial amount of Fed rate hikes and therefore begun the process of bracing for higher future short-term interest rates. The majority of primary dealers also expect a $10 to $20 billion reduction in the amount of monthly bond purchases from the Fed. So the recent rise in rates has gone a long way to price in a Fed exit and a reduction of greater than $20 billion may be necessary to spark another significant leg downward in bond prices. ■

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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.

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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.