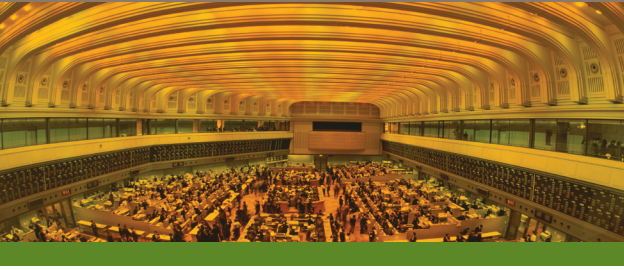


Bond Market Perspectives



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Auction Action

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Highlights

A full slate of European government bond auctions this week may reveal whether the recent rise in yields is sufficient to entice investors into European government bonds.

Investors have shown signs of fatigue with some government bonds and shown a preference to stay short-term as year-end approaches.

The strength of auction demand may determine how more economically sensitive bonds, including corporate bonds, high-yield, and emerging market debt, perform this week.

Has the rise in European bond yields finally reached the limit? A full slate of government bond auctions in Europe will be a focus for bond investors this week as they try to answer this question. Although investor buying habits and preferences are reflected in the current prices and yields of bonds already trading in the secondary market (i.e., those bonds already issued), new bonds sold at auctions can provide another glimpse into investor demand. Investors' willingness to commit money to a new security can often contradict secondary market pricing and spark a rally if demand is robust, or in the case of weak demand, a sell-off. This week (November 28-December 2) government bond auctions in Italy, Spain, and France may determine whether a further rise in yields along with optimism to start the week will be enough to entice investors. The strength of demand, or lack of it, may determine how equities—and more economically sensitive segments of the bond market—perform this week.

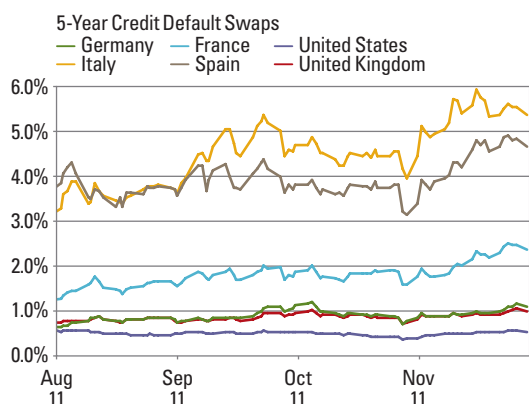
There are several ways to measure the strength of demand at an auction, but the most telling is to compare the dollar amount of investor offers to buy (called a bid) to the dollar amount of bonds for sale. The resulting ratio is known as the bid-to-cover ratio. For example, if investors submit orders totaling \$15 billion for a new \$5 billion bond auction, the bid-to-cover ratio is 3-to-1 (15 divided by 5). Another way to state this result is that the bond auction was three-times oversubscribed.

Government Fatigue

Last week, a German 10-year government bond auction made news headlines when investor bids fell well short of the €6 billion for sale and only 65% of the auction sold to investors. However, there is more to the headline than meets the eye. A “failed” auction, as it was called, is not uncommon in Germany and a total of five government bond auctions have “failed” in Germany over the past three months. Structural differences between the U.S. Treasury market and German Bund market help explain why government auctions can, and have, failed to attract sufficient demand. In the United States, the Federal Reserve (Fed) has a system of primary dealers—financial institutions required to participate in all Treasury auctions and also make secondary markets in all Treasury securities—which makes the odds of a “failed” auction in the Treasury market extremely low. When investor demand for a particular Treasury auction is weak, a greater portion of the auction will be purchased by primary dealers. Germany does not have



1 The Cost to Insure Against Default Increased for Major Government Bond Issuers in November



Source: Bloomberg, LPL Financial 11/28/11

CDS measure the cost to insure debt (% paid annually) against default.

2 Treasury Sensitivity to Equity Weakness is Beginning to Fade

Weeks when stock losses exceeded 2% (week ending)	S&P 500 Index Return	10-year Treasury Yield Change (%)
07/15/11	-2.1%	-0.12
07/29/11	-3.9%	-0.17
08/05/11	-7.2%	-0.24
08/19/11	-4.7%	-0.19
09/23/11	-6.5%	-0.22
11/04/11	-2.5%	-0.28
11/18/11	-3.8%	-0.05
11/25/11	-4.7%	-0.05

S&P 500 return and 10-year yield change for the entire week.

Source: Bloomberg, LPL Financial 11/28/11

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

such a system in place and the Bundesbank, Germany’s central bank, buys the unsold portion, as it did last week when demand fell short.

We view the German auction results as investors being more discerning and more cautious as is typically the case when year-end approaches. In our view, last week’s failed German bond auction was not an ominous sign, but rather an indication that investors are requiring higher yields for European government debt overall, and not just for peripheral European government bond issuers such as Italy and Spain. The amount purchased by the Bundesbank due to lack of demand, 35%, was significant and likely contributed to market weakness.

Government bond fatigue is not confined to Germany. Credit default swaps (CDS), the cost to insure against default, increased for all major government bond issuers in November [Chart 1]. Increased fear over Europe caused investors to price in a greater risk of default, even if minimal, for Germany compared to the United Kingdom, according to CDS pricing.

Skepticism over government bonds globally extended to Treasuries in November, albeit modestly, and may have been partially due to failure of the Congressional super committee. Addressing a large debt burden is not a problem confined to Europe and must be dealt with here in the United States as well. Failure of the super committee to come to agreement over \$1.2 trillion in budget cuts raises concerns over politicians’ ability to tackle greater challenges in the future. Treasuries’ safe-haven status is not likely to be challenged anytime soon, but progress on deficit reduction will need to occur in coming years or the United States faces a similar risk of rising interest rates. The cost to insure Treasuries against default over a 5-year horizon increased by a modest 0.05% last week to 0.56%, according to CDS [Chart 1]

Although the CDS change was small, restraint was evident in the regular Treasury market as well. Treasury prices rose last week and yields declined but the 10-year Treasury was once again unable to deviate far from the 2.0% yield that continues to act as a center of gravity as discussed in last week’s Bond Market Perspectives. Treasuries will likely continue to benefit from safe-haven flows but have recently exhibited less sensitivity to equity weakness. Over the past two weeks, the broad stock market, as measured by the S&P 500 Index, declined by 3.8% and 4.6%, respectively, but the 10-year Treasury yield declined by a modest 0.05% each week. Other periods of pronounced equity weakness in recent months have witnessed at least a double-digit decline in the 10-year Treasury yield [Chart 2].

The Year-end Trend

With European government bonds under pressure and waning enthusiasm for Treasuries as a safe haven, investors appear to have shifted focus towards short-term bonds as year-end approaches. Last week’s auction of 2-year Treasury notes and a Fed sale of short-term Treasuries as part of Operation Twist stand out. The Fed received bids totaling \$143 billion for \$8.5 billion in short-term, 15- to 18-month Treasuries for sale as part of Operation Twist, a whopping 16-times oversubscribed! Just two hours after



the Fed operation, the Treasury's sale of new 2-year notes was four times oversubscribed, a record for the 2-year Treasury auction. Lastly, despite weakness at Germany's 10-year government auction last week, yields ranging from three months to two years were unchanged for the week also indicating investor preference to stay short-term.

We believe the approaching year-end is exacerbating concerns over Europe and pushing investors to focus their attention on short-term, high-quality bonds. This week's auctions in Europe, and efforts towards achieving greater fiscal union, may alter investor preference to stay short-term and refocus on more economically sensitive bonds, such as corporate bonds, high-yield, and emerging market debt, that we continue to find attractively valued and we believe offer better longer-term return prospects for bond investors.

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A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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