

Bond Market Perspectives

March 8, 2011



Anthony Valeri, CFA

Market Strategist
LPL Financial

Highlights

Over the past four weeks, the combination of lower Treasury yields and higher inflation fears suggests the bond market may be signaling the return of stagflation.

We believe it is too early to declare a return to stagflation and several factors are responsible for recent market action.

Should recent trends persist, it would reinforce the low return environment for bonds.

Is the Bond Market Signaling Stagflation?

Over the past four weeks, the combination of lower Treasury yields and higher inflation fears suggests the bond market may be signaling the return of stagflation. Normally, higher inflation expectations would translate into lower bond prices and higher yields as investors demand protection from rising inflation that erodes the value of bond investments over time. However, the fact that high-quality bond yields declined over the past four weeks while inflation expectations increased suggests that the bond market may be pricing in both slower economic growth and higher inflation, otherwise known as stagflation [Chart 1].

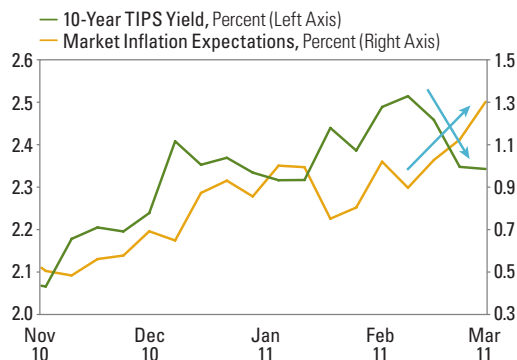
The mention of stagflation conjures up memories of the 1970s. For investors, it does not mean bell-bottoms and big-collar shirts but rather a period of merely average economic growth but with above-average inflation. Economic growth, as measured by gross domestic product (GDP), averaged 3% in the 70s while inflation, as measured by the consumer price index (CPI), averaged just over 7%. Job creation was problematic for much of the decade as well. Unemployment rose above 6% in late 1974 and did not fall back below that threshold until the middle of 1978. These elements are in play today but to varying degrees.

Overall economic data for the U.S. economy has been robust (see the current *Weekly Economic Commentary* for details) but job creation, the ultimate test of an economy's vitality, continues to be lackluster. Last Friday's employment report showed that employment continues to improve but at a very sluggish pace. Meanwhile, lingering Middle East turmoil has helped keep oil prices above \$100 per barrel. Since higher energy prices act as an added tax on consumers and consumer spending accounts for nearly 70% of economic growth, lower bond yields reflect the bond market pricing in a slower pace of economic growth going forward.

Last week, the Federal Reserve's Beige Book release, a qualitative and monthly report on regional economic conditions, added fuel to inflation fears. The Beige Book reported that some firms are having initial success in passing on higher input costs to end users or consumers. The report runs contrary to the belief that the economy is not strong enough to handle higher prices. The ability to more easily pass along higher costs reinforced inflation fears.

We believe it is too early to declare a return to stagflation. We are watching recent developments closely but it may simply boil down to uncertainty weighing on bond investors. On the one hand, economic data continues

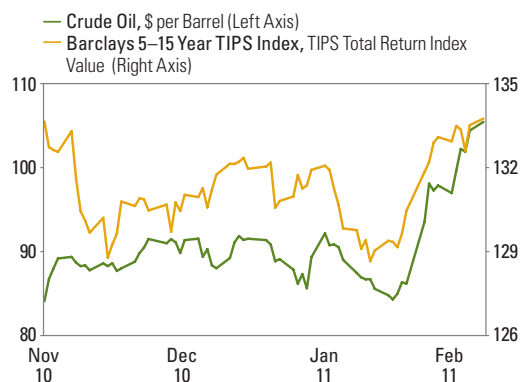
1 A Combination of Lower Yields and Higher Inflation Expectations Suggest Stagflation



Source: Bloomberg, LPL Financial 03/07/11



2 TIPS Benefited from Higher Oil Prices



Source: Bloomberg, Barclays, LPL Financial 03/07/11

The Barclays 5-15 year TIPS Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

to improve and in some cases, such as last week’s Institute of Supply Management (ISM) survey, is very strong. On the other hand, rising energy prices are a concern and may slow future economic growth. However, today the U.S. economy is more energy efficient and much less dependent on oil than it was in the 1970s casting doubt at what level oil prices truly impact the economy. In addition, recent Treasury strength is also attributable to Middle East turmoil and fears that geopolitical risk may spread to more systemically-important countries such as Bahrain or Saudi Arabia.

Bond market uncertainty is also reflected in sector performance. Over the past four weeks (ending March 7, 2011), sector performance among Treasury, mortgage-backed, investment-grade corporate, emerging market debt, and high-yield bonds has held in a narrow band. TIPS are an exception, however, and have benefited directly from higher oil prices [Chart 2]. The lack of true sector leadership, aside from the oil-induced gains in TIPS, also reflects bond market uncertainty.

3 10-Year Treasury Yield During the 1970s



Source: Bloomberg, LPL Financial 03/07/11

Today’s bond market bears little resemblance to that of the 1970s making it hard for investors to draw investment conclusions. Many domestic (e.g., high-yield bonds) and international bond sectors simply did not exist in the 70s. However, a simple glance at the 10-year Treasury yield shows that bond investors faced an uphill battle for most of the decade [Chart 3]. Note the gradual nature of the rise in yields for much of the decade suggests downward price pressures. To what degree price pressures are offset by interest income depends on a particular bond sector or investment but today’s lower yield levels provide less of a cushion. As we have argued in the past, lower yields imply lower returns going forward. We forecast a low return environment for bonds in our *2011 Outlook*, but should stagflation trends become more entrenched, bond investors will likely face a low return environment well beyond 2011.

We are watching recent bond market developments closely but believe it is too early to signal a return to stagflation. Lingering Middle East turmoil, which has contributed to high oil prices and safe-haven buying of Treasuries makes it difficult to discern a true trend. Last week’s Beige Book report was a warning shot that higher inflation may be here to stay even if geopolitical risks recede, but the lack of true sector leadership and decline in overall bond yields suggests recent bond market action merely reflects uncertainty.



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 reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, are subject to availability, and change in price.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

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.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. Government.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

The ISM index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management. The ISM Manufacturing Index monitors employment, production inventories, new orders, and supplier deliveries. A composite diffusion index is created that monitors conditions in national manufacturing based on the data from these surveys.

The Barclays 5-15 year TIPS Index consists of Inflation-Protection securities issued by the U.S. Treasury with a maturity from 5 up to (but not including) 15 years.

This research material has been prepared by LPL Financial.

The LPL Financial family of affiliated companies includes LPL Financial and UVEST Financial Services Group, Inc., each of which is a member of FINRA/SIPC.

To the extent you are receiving investment advice from a separately registered independent investment advisor, please note that LPL Financial is not an affiliate of and makes no representation with respect to such entity.

Not FDIC or NCUA/NCUSIF Insured | No Bank or Credit Union Guarantee | May Lose Value | Not Guaranteed by any Government Agency | Not a Bank/Credit Union Deposit