

Bond Market Perspectives



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Falling Behind

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Highlights

Rising inflation concerns have bond investors beginning to fear the Fed may be falling behind.

Nervousness ahead of this week's combination of key economic data and another round of Treasury auctions also spurred high-quality bond weakness last week.

We expect high-quality bond prices to remain under pressure and Treasury yields may retest recent highs.

Rising inflation worries and an interest rate hike by the European Central Bank (ECB) have U.S. bond investors beginning to fear that the Federal Reserve may be falling behind. Last week's bond market reaction seemed to confirm such fears as long-term Treasury yields increased more than short-term Treasury yields and Treasury Inflation Protected Securities (TIPS) also outperformed conventional Treasuries. The bond market was not alone, however, as currency and commodity markets also reflected rising inflation concerns. For bond investors, the inflation concern means that high-quality bond prices will remain under pressure in a potentially pivotal week for the bond market.

In the Treasury market, a greater rise in long-term yields and an increase in market inflation expectations, as measured by TIPS, were the two visible signs of inflation concerns driving bond market reaction. Yields on 10- and 30-year Treasuries increased by 0.14% and 0.16%, respectively, compared to a minor 0.01% rise in the 2-year Treasury yield. Longer maturity bonds are more sensitive to changes in expected inflation while short-term bonds, such as the 2-year, are more sensitive to expected interest rate changes by the Federal Reserve.

The inflation rate implied by pricing on 10-year TIPS increased by 0.13% last week to 2.65%, the highest level since late 2006 [Chart 1]. The rise in the "breakeven rate," so called because it reflects the rate at which an investor is indifferent between owning a 10-year TIPS or a 10-year conventional Treasury, reflected greater investor concern over future inflation and caused TIPS to outperform conventional Treasuries on the week.

Inflationary concerns were visible in the currency and commodity markets as well. The US dollar declined 1% on the week, as measured by the DXY Index, and the Commodities Research Bureau (CRB) Index increased by over 2%.

The ECB became the first major central bank, among developed countries, to raise interest rates last week and added to concerns that the Fed may be falling behind. The ECB raised its overnight lending rate by 0.25% to 1.25%. Although ECB President Trichet attempted to downplay fears of steady rate increases, investors were not convinced and futures are priced to reflect another three rate increases over the remainder of 2011. In addition, the Bank of England is expected to produce its first interest rate increase to combat inflation as early as June.

1 Inflation Expectations Rose to Their Highest Level Since Late 2006



Source: Bloomberg, LPL Financial 04/08/11



Growing dissention among Fed officials is not helping market perception. Bond investors pay close attention to public comments from Fed officials to gain clues about the potential timing of changes to monetary stimulus or interest rates. Last week, Dallas Fed President Richard Fisher stated the Fed may be overstaying its welcome in the bond market and that Fed stimulus is nearing a “tipping point.” His remarks followed comments in late March from St. Louis Fed President James Bullard who stated that Treasury purchases may need to be curtailed early given strength in the economy and signs of rising inflation. Philadelphia Fed President Charles Plosser followed up by suggesting a rate increase is “certainly possible” before the end of 2011.

On the other hand, Fed Chairman Ben Bernanke, New York Fed President William Dudley and Vice Chairman Janet Yellen have issued benign comments and labeled the rise in commodities prices as transitory and not likely to materially impact inflation. At the end of the day, Bernanke and Yellen, the second most influential member at the Fed, will hold influence but the dissention has caught the attention of bond investors and added an element of uncertainty.

A Case of Nerves

Although rising inflation expectations played a role last week, investor nervousness likely contributed to bond weakness. Specifically, nervousness ahead of economic data and Treasury auctions that could make the current week a pivotal, make-or-break event for the bond market likely contributed to bond market weakness.

Bond investors reacted in anticipation of:

- **A big week of economic data** – The current week holds key economic data on inflation that may sway investor sentiment. In addition, monthly retail sales data will provide a glimpse of whether consumer spending habits were adversely affected by higher energy prices in March. Concern over faster-than-expected inflation, as measured by the consumer price index (CPI), and/or consumer resilience to higher energy prices may have also pressured bond prices lower.
- **Another round of Treasury auctions** – Fresh supply of 3-, 10-, and 30-year Treasury securities will be auctioned this week starting with the 3-year note on Tuesday as this publication goes to print. Longer-term 10- and 30-year Treasury auctions are always a good test of market demand and fear that bond yields may not have been high enough to ensure adequate demand may have played a role in bond weakness last week.

Like all markets, the bond market is forward-looking and it is not uncommon to witness market participants build in a buffer, in the form of price concessions, ahead of potentially market-moving events.

High-quality bonds are likely to remain under pressure this week as bond investors assess whether last week’s weakness was precautionary or a genuine fear of rising inflation risks. The current week may provide that extra clarity but will still pose a challenge for the bond market. Not only is

We believe bond yields will continue to be pressured upward and the 10-year Treasury yield may retest the 3.75% high of mid-January in coming weeks with a challenge of the psychologically important 4.0% yield also in reach.

2 The 10-Year Treasury Yield May Retest the Recent High



Source: Bloomberg, LPL Financial 04/11/11

the economic data significant but also timing is tricky. Concern over Friday's CPI release may temper demand for Wednesday's and Thursday's Treasury auctions. We believe bond yields will continue to be pressured upward and the 10-year Treasury yield may retest the 3.75% high of mid-January in coming weeks with a challenge of the psychologically important 4.0% yield also in reach [Chart 2]. More economically sensitive securities such as high-yield bonds, bank loans, and preferred securities are best way to invest while high-quality bonds remain under pressure.

IMPORTANT DISCLOSURES

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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.

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.

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.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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.

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.

Bank Loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Preferred Stock investing involves risk which may include loss of principal.

This Barclays 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 U.S. Dollar Index (DXY) indicates the general international value of the US dollar. The DXY Index does this by averaging the exchange rates between the US dollar and six major world currencies.

International investing involves special risks, such as currency fluctuation and political instability, and may not be suitable for all investors.

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The Commodity Research Bureau (CRB) Index is an index that measures the overall direction of commodity sectors. The CRB was designed to isolate and reveal the directional movement of prices in overall commodity trades.

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