

Bond Market Perspectives



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Lagging Indicator

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Highlights

We view Standard & Poor's (S&P's) placement of U.S. Treasuries on outlook negative as just another factor in the push-and-pull on Treasury yields in 2011.

We do not see S&P's action as a material increase in default risk for U.S. Treasuries.

By the time additional ratings news occurs it will likely be already accounted for by the bond market. Economic growth and inflation along with Federal Reserve policy will be the primary driver of Treasury yields.

Within the bond market, the ratings agencies are viewed as lagging indicators and S&P's action to place the AAA-rating of U.S. Treasuries on negative outlook may have cemented that reputation. S&P's announcement was hardly "news." The rising U.S. debt burden and threat of future entitlement spending is already well-known and remains a future risk to the AAA-rating of U.S. Treasuries. So while the decision was not entirely surprising, the timing was. It follows increasing talk from Washington on reducing the budget deficit and the debt burden facing the United States. We view S&P's move as just one more factor in the push-and-pull on Treasury yields. Overall, we continue to believe that economic growth, inflation, and Federal Reserve policy will exert a greater influence on Treasury yields in 2011.

Moody's, the other major ratings agency, reaffirmed the AAA-rating of U.S. Treasuries (as S&P did) but, in contrast to S&P, maintained U.S. Treasuries on outlook stable precisely because of Washington's recent tone towards addressing the deficit. In the past few weeks, Representative Paul Ryan has proposed a budget that reduces the deficit by \$4 trillion over 10-years. Last week, President Obama responded with a proposal that aims to reduce the deficit by \$4 trillion but over 12-years. Moody's cited the heightened focus as a positive development. In this context, the timing of S&P's move is somewhat puzzling.

We do not see S&P's action as a material increase in default risk for U.S. Treasuries. The 2-year Treasury note would not offer a low yield 0.66% and the 10-year Treasury Inflation Protected Security (TIPS) would not yield 0.75% if investors believed Treasuries were to default. The cost to insure against a Treasury default, as measured by Credit Default Swaps (CDS)—another market-based barometer of credit quality—increased to 0.49% from 0.42%, following the news but remains low compared to AAA-rated sovereign counterparts. CDS for Germany, France, and the U.K. closed Monday at 0.46%, 0.78%, and 0.58%, respectively. By mid-day Tuesday, CDS for U.S. Treasuries had declined by 0.2% to 0.47% meaning that it costs \$47,000 per year to insure \$10,000,000 of Treasuries against default over a 5-year time horizon.

The U.K. may serve as a comparison for Treasuries. U.K. government debt was placed on outlook negative by S&P back in May 2009 for high debt levels, similar to the U.S. The U.K. Gilts never lost their AAA-rating and last October S&P revised the outlook upwards to stable. S&P's upgrade to



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stable did not have much impact as 10-year U.K. government bond prices rose steadily over the second and third quarters of 2010 due to European debt concerns and fears of a double-dip global recession. Despite S&P's outlook change to stable in October, U.K. government bond prices declined during the fourth quarter of 2010 as investors began to expect stronger global economic growth in response to the Fed's expanded bond purchase program. Investor expectations about economic growth ultimately had the greater influence on the bonds.

Perhaps unsurprisingly, bond markets quickly saw through the S&P announcement and refocused on one of the bigger drivers of bond yields: economic growth. Price declines related to credit quality fears over the AAA-rating of U.S. Treasuries were more than offset by renewed economic growth concerns and a flare up of European debt concerns. Treasury prices ultimately closed higher on the day. China's central bank raised reserve requirements for the fourth time this year in an attempt to rein in economic growth and combat inflation. China's latest attempt to step on the brake pedal raised fresh concerns about global economic growth as investors questioned the degree of future action and whether it would adversely impact faster growing emerging market countries. In Europe, talk of Greece defaulting on its government bonds led to broad-based weakness among peripheral European government bonds. Although Greek government bond pricing had already reflected a strong possibility of a default/debt restructuring, the latest news raised the fears of systemic market risks and the impact on broader Europe.

1 The Tug-of-War Continues: The 10-Year Treasury Yield is Back in the Middle of the Trading Range



Source: Bloomberg, LPL Financial 04/19/11

We view the S&P action as another factor in the push-and-pull on U.S. Treasury yields. The holiday shortened week was supposed to be a quiet one in the bond market but has been anything but so far. Despite a light economic data calendar, the absence of public speeches from Federal Reserve officials, and the potential for light trading volume due to the absence of market participants around the holidays, the start of the current week has been anything but quiet. Another move by China to tighten monetary policy to combat rising inflation, a flare up in European debt concerns, and S&P's placement of U.S. Treasuries AAA-rating on outlook negative made for a volatile start. All three events highlight the push-and-pull that may keep bond yields range-bound in 2011. Treasury yields now sit in the middle of this year's trading range [Chart 1].

Last week, we anticipated that the difficult combination of Treasury auctions and economic data would pressure Treasury yields higher to the upper end of our expected yield range for 2011. Instead, strong demand at the 30-year Treasury auction coupled with inflation readings that were more benign than anticipated supported Treasuries and pulled yields lower by 0.1% to 0.2%. Concern over future economic growth has become a rising theme in the bond market and also played a role in pulling yields lower. President Obama's speech to address the budget deficit with a combination of tax increases and spending cuts were viewed as anti-growth by investors and supported Treasuries. The impact of austerity here in the U.S., not just Europe, is being factored into the bond market.



If and/or when Treasuries lose their AAA-rating, the bond market will likely have already factored in the outcome (see the February 1, 2011 *Bond Market Perspectives – What’s in a Rating?*). The ratings agencies will have likely been late to the party again. We believe growth and inflation along with actions of the Federal Reserve will ultimately be the primary driver of Treasury yields, not potential ratings news.

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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 a fund shares is not guaranteed and will fluctuate.

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