

Bond Market Perspectives



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The End of QE2

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Highlights

In our view, supply/demand dynamics are not a primary driver of yields in the taxable bond market and play a secondary role.

Once Fed buying ends, we do not believe yields are poised to spike upwards as other market participants have the capability to fill the void left by the Fed.

We believe economic growth and inflation will have a greater impact on Treasury yields once QE2 ends.

We do not expect the end of QE2 to alter our expectation for a 3.0% to 4.0% yield range on the 10-year Treasury in 2011.

One of the most persistent questions facing bond investors is what happens to the bond market once the Federal Reserve's (Fed) \$600 billion Treasury bond purchase program, known as QE2 (Quantitative Easing), ends this June. The Fed continues to purchase approximately \$100 billion of Treasury notes and bonds every month. Of that total, roughly \$75 billion are attributable to the \$600 billion QE2 purchase program with the remainder, roughly \$25 billion, attributable to the reinvestment of proceeds from the Fed's holdings of mortgage-backed securities (MBS). The Fed is widely expected to continue reinvesting MBS proceeds into Treasuries; however, the end of \$75 billion of Fed buying power still leaves the Treasury market with a significant void.

Although Treasury borrowing needs peaked about a year ago, the Treasury is still on pace to issue a significant supply of new bonds. The Fed's monthly \$75 billion buying power would go a long way to soaking up net Treasury issuance in coming months [Table 1]. Will interest rates spike higher, pushing bond prices sharply lower in response to the absence of a significant Treasury buyer?

In our view, supply/demand dynamics are not a primary driver of bond yields and play a secondary role. Plugging a \$75 billion monthly buying gap is not an insurmountable task for the Treasury market, but to see why it is not an insurmountable task we must first take a look back at the start of QE2. Fed data reveals that just as the Fed began to buy Treasuries en masse in November 2010 other buyers curtailed purchases. Foreign investors, the largest buyer of Treasuries, curtailed buying sharply during the fourth quarter of 2010. Overseas investors reduced purchases from an average of \$88 billion per month during the third quarter of 2010, according to Fed data, to just over \$41 billion per month during the fourth quarter of 2010, less than half the pace of the third quarter. Banks, the sixth largest holder of Treasuries and a prominent buyer in recent quarters, were net sellers of Treasuries during the fourth quarter as were households, the second largest group of Treasury holders. Private pension funds, the fourth largest holder of Treasuries, also reduced Treasury purchases during the fourth quarter just as the Fed began its buying spree.

Foreigners, banks, pensions, and households may be poised to take up the slack. According to the same Fed data, foreigners bought roughly \$56 billion in Treasuries per month over the past three years. An increase back to the three-year average would imply a \$15 billion increase in buying demand.

1 The Fed's Buying Would Help Absorb Upcoming Treasury Supply

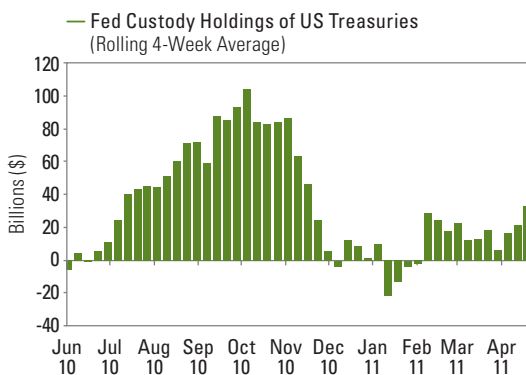
Expected Net Treasury Issuance	
Month	Billions (\$)
June	114
July	118
August	94
September	114
October	112
November	90
December	84

Source: Treasury Department, LPL Financial 04/29/11

Net issuance based upon maturing Treasury debt and expected Treasury borrowing needs.



2 Foreign Buying of Treasuries Has Increased Recently



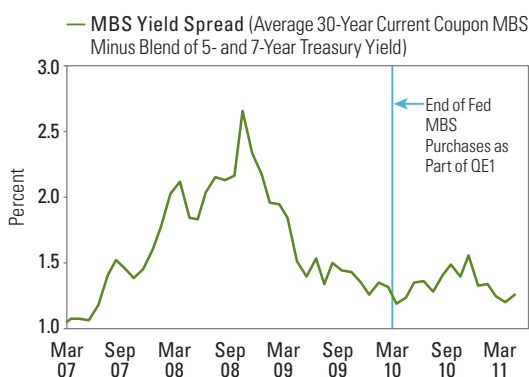
Source: Federal Reserve, LPL Financial 04/27/11

Similarly, pensions, banks, and households purchased an average of \$31 billion in Treasuries per month over the past three years. This group was a net seller of \$5 billion in Treasuries during the fourth quarter but an increase back to the three-year average would imply \$36 billion in additional buying power. Taken together, the other major buyers of Treasuries could make up for \$51 billion in buying power, which accounts for a good portion of the \$75 billion in the absence of the Fed.

That dollar amount does not fully cover the gap, suggesting the absence of the Fed may have a modest, upward bias to Treasury yields. However, the dollar amount is not, in our view, enough to create a substantial sell-off in high-quality bonds. Furthermore, if foreigners, banks, and pensions return to their third quarter buying habits, then the \$75 billion gap could more than be accounted for. At their peak, households purchased \$59 billion in Treasuries per month during the second quarter of 2010. While we do not expect a return to that level of buying, it shows that the household sector also has buying power. Taken together we believe there is enough potential buyer power to keep any rise in bond yields limited.

In fact, foreign buyers may already be taking up the slack. Although comprehensive Fed data on first quarter 2011 Treasury holdings will not be released for another two weeks, weekly data on foreign Treasury holdings held in custody at the New York Federal Reserve Bank reflect foreigners have increased purchases in recent weeks [Chart 2] after a period of minimal buying in late 2010 and early 2011. Part of this is due to the continued growth of reserves which need to be invested. On a related note, the continued strength in commodity prices provided commodity-exporting nations with excess cash, some of which is finding a home in the Treasury market.

3 MBS Valuations Showed Only Modest Weakness at the End of Fed Buying



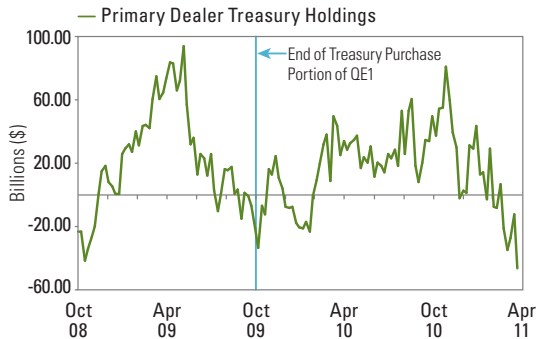
Source: Bloomberg, LPL Financial 04/29/11

A Prior Example

A review of the Fed’s MBS suggests that supply could have a modest upward impact to Treasury yields. During QE1, the Fed purchased \$1.25 trillion of MBS, roughly 25% of the entire MBS market. At the end of QE2, the Fed will own approximately 13% percent of outstanding Treasury notes and bonds, a much smaller portion but still a relevant comparison. Viewing the change in the average MBS yield advantage, or spread, to Treasuries suggests the absence of the Fed may have led to only minor weakness of the MBS market [Chart 3]. We say “may have” since multiple factors influence MBS yield spreads, including interest rate volatility and mortgage prepayments, but the timing is uncanny. The average MBS yield advantage increased by 0.2% over the second quarter of 2010 after widening by as much as 0.4% briefly but much of that was due to the strong flight-to-safety rally in response to European debt fears and the flash crash that led to Treasury gains and outperformance within the bond market. More likely, the end of Fed buying was one of several factors that led to wider MBS yield spreads but, on balance, the MBS market held in remarkably well despite the absence of the Fed.



4 Primary Dealer Holdings of Treasuries are at Their Lowest Levels Since the End of QE1



Source: Treasury Department, LPL Financial 04/20/11

Part of the resilience of the MBS market is attributable to a more normal market function. Fed buying can disrupt the normal flow of markets and cause market participants to alter their behavior. Fed MBS purchases led to valuation distortions of certain types of securities keeping some investors on the sidelines when they would normally be active. Our conversations with investment managers and traders revealed that regular buyers returned to the market once the Fed MBS purchase program ended.

Similarly, Fed buying of Treasuries has also disrupted purchasing habits of regular Treasury buyers. Primary dealers have been net sellers of Treasuries in response to Fed purchases [Chart 4]. Note that primary dealers, the 18 firms that are required to make markets in all Treasury securities, are currently net short Treasuries. A similar situation occurred during QE1, the Fed's Treasury bond purchase program. Primary dealers began to cover those short positions by buying Treasuries just before the completion of QE1 in October 2009. Primary dealers may increase their buying in coming months once again and help take up any buying slack as markets resume a more normal function once the Fed's large-scale purchases end.

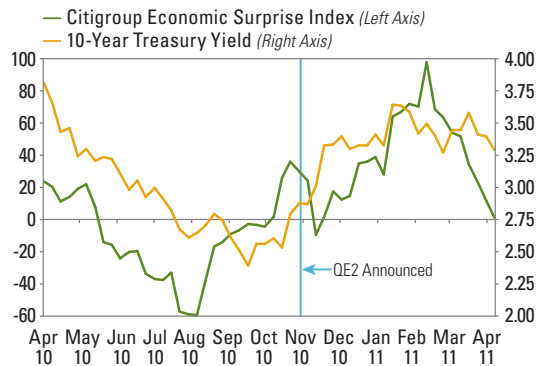
So What Does Move Bond Yields?

We believe the bond market will once again react to the classic primary drivers of interest rates: inflation, economic growth, and Federal Reserve interest rate changes. With the Fed unlikely to increase interest rates in 2011, the bond market will maintain focus on the economy and inflation. Economic growth helps explain much of the change in Treasury yields over the past few months as the two have been closely linked [Chart 5]. The greater the expected economic growth level, the greater the inflation risk and the higher interest rate demanded by bond investors as compensation for such risks and vice versa. The economic surprise index compares the number of economic reports exceeding expectations versus the number of economic reports failing to meet expectations and therefore used as a leading indicator of the economy.

Chart 5 reveals that economic growth expectations also drove yield changes during the fourth quarter of 2010. Interestingly, the net supply outlined in Table 1 in the outset is little changed from that of the fourth quarter of 2010. Perhaps a better question is why did interest rates rise from October 2010, just before the Fed began to expand purchases, even though the Fed was buying the vast majority of net new issuance? In our view, the answer lies in rising investor expectations about future economic growth. Similarly, some modestly weaker-than-expected data fueled the recent decline in the 10-year Treasury yield back to 3.3%.

Should other large participants mentioned above not step up buying we believe the supply/demand dynamic would play a secondary role and may exert modest upward pressure to Treasury yields on the order of 0.2% to 0.3%, based in part upon the MBS experience. Still, we believe economic growth expectations will continue to have a greater influence on the overall level of Treasury yields come June. We do not expect the end of QE2 to alter our expectation for a 3.0% to 4.0% yield range on the 10-year Treasury in 2011.

5 Economic Growth is a More Dominant Driver of Treasury Yields



Source: Citigroup, LPL Financial, Bloomberg 04/29/11



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.

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.

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.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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.

Spread is the difference between the bid and the ask price of a security or asset.

The Citigroup Economic Surprise Index is an objective and quantitative measure of economic news. It is defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The index is calculated daily in a rolling three-month window.

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