Bond Market Perspectives

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Flirting with 3%

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Highlights

The current low level of Treasury yields may persist as investors evaluate the economic soft spot.

Despite positive momentum, further declines in Treasury yields are likely limited as valuations approach a near-term peak.

The 10-year Treasury yield recently closed below the psychologically important 3.0% level for the first time since December 2010. Was the move an inappropriate transgression or justified and proper based upon the economic data? Over the past week, the 10-year Treasury yield has retraced the move twice indicating regret. The lack of near-term catalysts suggests the market may wait a few weeks before casting judgment. In the meantime, the 10-year Treasury yield may fancy another pass at 3.0% and perhaps lower. For bond investors, this means that high-quality bonds are likely to hold recent gains over the near term.

In our view, the economic data has justified the current low level of yields and higher Treasury prices. The May employment report and the May Institute of Supply Management (ISM) manufacturing survey both reflected a slowdown in the economy. These two top-tier economic reports punctuated a run of weaker-than-expected economic data in recent weeks and the ensuing safe-haven buying propelled high-quality bonds for an eighth consecutive week.

A lack of catalysts suggests that high-quality bonds are likely to hold recent gains over the near term. As is typically the case following the monthly jobs report, the economic data calendar enters a lull. The next important economic release will be the monthly retail sales report for May on June 14, 2011. Weekly jobless claims will be closely scrutinized for improvement as well but, by the end of June, annual auto plant shutdowns will distort the data and limit the usefulness of the weekly report. Given how quickly the economic data slowed, bond investors will likely wait to see improvement in several economic reports, not just one, before a reversal in high-quality bond prices and yields is warranted. Investors will likely wait until the next round of top-level ISM and employment data for June, released in early July, to see whether the economy is showing signs of emerging from the soft spot.

In the absence of significant domestic economic reports over the coming two weeks, global catalysts may auger for still lower Treasury yields. China stands ready to raise interest rates to clamp down on economic growth should the coming round of economic data show that inflation remains too high. If China raises interest rates or attempts to restrain bank lending further, investor fears over the health of the global economy may intensify and high-quality bonds may benefit from safe-haven buying. Similarly, the European Central Bank (ECB) will convene later this week. Although no interest rate hike is expected from the ECB, any indication that more interest

1 The 10-Year Treasury Yield Reached the 3% Level for the First Time Since Last Year

Source: Bloomberg, LPL Financial 06/06/11

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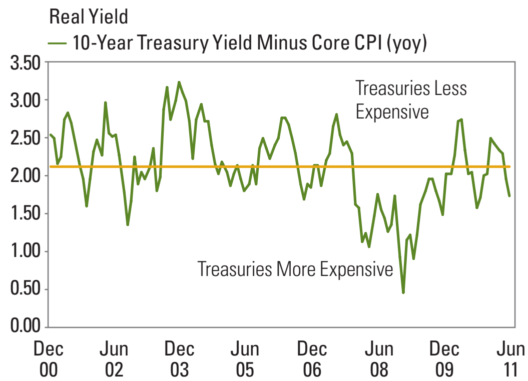
2 Treasury Valuations are Approaching Their Most Expensive Levels Since Last Summer



Source: Bloomberg, LPL Financial 06/03/11

rate increases are coming soon may exacerbate European debt fears. Demand for U.S. Treasuries and high-quality bonds may increase in response.

Although catalysts to still lower yields loom, a further decline in Treasury yields is likely to be limited in our view. Treasury valuations, as measured by inflation-adjusted or real yields, have reached their most expensive level since late summer/early fall of last year when double-dip recession fears were widespread [Chart 2] and bond investors were anticipating expanded Treasury purchases. The lower the real yield, the more expensive high-quality bond valuations are and vice versa. We believe part of the market's hesitation around the psychologically important 3.0% yield level is simply a realization that valuations may be nearing a peak. Current valuations are not far from a level that served as a reversal point to higher yields last fall.

Additional Treasury gains may push the 10-year Treasury yield to cross the line below 3% again, but we do not expect intermediate- and long-term Treasury yields to retest the lows of last autumn. The now higher level of inflation means that Treasury valuations would have to reach a more expensive level than witnessed during late summer/early fall of last year. A return to recession would warrant such valuations but we believe the economy will avoid recession as disruptions from the earthquake in Japan and impacts from severe weather in the central and southern United States will abate with economic growth picking up later in the summer and fall.

The slowdown in the economy motivates us to turn cautious on more economically sensitive bond market sectors, such as high-yield bonds, but we believe such sectors still possess the better total return prospects when looking out over the remainder of the year. While Treasuries may hold onto gains over coming weeks, we find their longer-term prospects unattractive. Meaningful additional gains to Treasuries are only likely to come from a return to recession, which is not our base case forecast.

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.

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.

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.

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 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.