

Bond Market Perspectives

June 28, 2011



Anthony Valeri, CFA

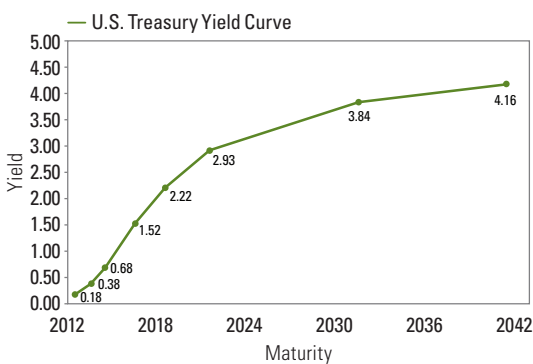
Market Strategist
LPL Financial

Highlights

The yield curve is one of the more reliable market-based indicators of economic health.

The current steep slope of the yield curve is a long way away from signaling recession, indicating the bond market believes the global economic expansion remains on track.

1 An Upward-Sloping Yield Curve Signals Economic Growth Not Recession



Source: Bloomberg, LPL Financial 06/17/11

The Yield Curve Signals No Recession

Concerns over a return to recession pushed Treasury yields still lower last week but one classic bond market indicator is very far from signaling a recession: the yield curve. The yield curve, so named because it graphically represents the relationship of yield for a given maturity date, has historically been a reliable indicator of economic health. Currently the yield curve is upward-sloping [Chart 1], a sign that the bond market is signaling continued economic growth over the next year, not recession. The incrementally higher yields for longer maturity bonds reflect an economy that is expected to grow and the higher yields required to compensate investors not only for uncertainty about how strong growth will be but also for longer-term inflation risks that accompany an expanding economy.

A downward-sloping, or inverted, yield curve has preceded every recession as lower yields on longer-term bonds signal slower future growth, and reduced inflation risks. It is also a bond market signal to the Federal Reserve that short-term interest rates are too high and need to be cut in order to stimulate economic growth. The yield curve's excellent track record of foreshadowing a recession is evident in Chart 2. The slope of the yield curve can also be measured by subtracting the yield of a short-term bond from that of a longer-term bond, in this case subtracting the 2-year Treasury yield from that of the 10-year Treasury yield. A negative yield differential means that longer-term bond yields are lower than short-term bond yields and the yield curve is inverted.

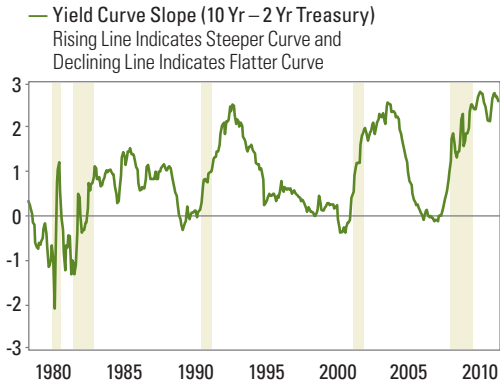
The yield curve is a leading indicator and therefore signals a recession 12 to 18 months in advance. In Chart 3 we shift the yield curve forward by one year and overlay quarterly economic growth as measured by gross domestic product (GDP).

All the charts reveal that the yield curve is very far from actually signaling a recession. The yield differential between 2-year and 10-year Treasury yields is very wide and indicative of a "steep" yield curve, which firmly indicates growth. To be sure, part of the steepness of the yield curve also reflects an accommodative Fed. The yield curve has "flattened" recently as economic data has disappointed over the past several weeks and the yield differential between short-term and long-term bonds has narrowed (leading to a flatter slope of the yield curve, hence the term) reflecting concerns over a slowdown.

A flatter yield curve has traditionally signaled a slow down in economic growth. The yield curve flattened noticeably in late 1994 as a series of Fed



2 An Inverted Yield Curve Has Preceded Every Recession



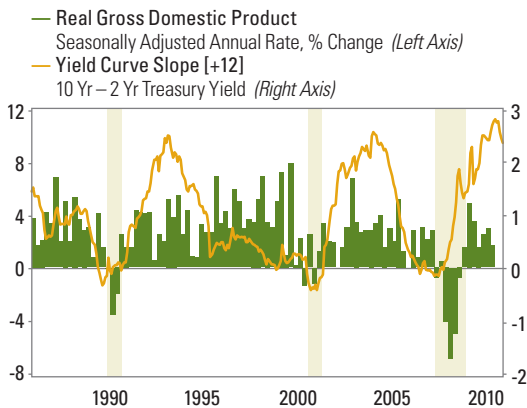
Source: LPL Financial, Haver Analytics 06/16/11

(Shaded areas indicate recession)

rate hikes were expected to slow the economy and reached a very flat level in 1998 in response to fears over the economic impact of the Asian financial crisis. Nonetheless, the Treasury yield curve today remains very steep which by historical standards is a reflection of the bond market betting on growth.

Yield curves around the globe reflect different signals regarding the local economy. In Japan, the yield curve is positive and upward-sloping, albeit not as much in the United States, reflecting investors' belief that coming reconstruction efforts will result in positive economic growth. In Brazil, the yield curve for government bonds denominated in the local currency, the real, is slightly inverted [Chart 4]. This reflects the conflicting forces of a central bank that may hike interest rates more to combat inflation while longer-term yields remain high but have declined due to the current economic slowdown and expectations of slower growth as a result of interest rate increases. We do not view the inverted Brazilian yield curve as signal for recession in Brazil as other factors are present. The high overall bond yields reflect inflation risks, currency risks, and high short-term rates. However, lower long-term yields reflect the bond market warning of a slower pace of future economic growth and illustrates what the shape of the yield curve means for an economy.

3 The Yield Curve and GDP

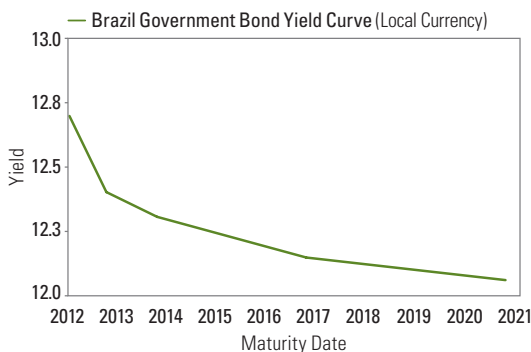


Source: LPL Financial, Haver Analytics 06/16/11

(Shaded areas indicate recession)

Financial markets can provide a guide to the future health of the economy. In the bond market, the yield curve is one of the most useful indicators regarding the future health of the economy. A flatter yield curve signals slower growth while an inverted yield curve has always preceded a recession in the United States. The current steep slope of the Treasury curve indicates the bond market believes the economic expansion remains on track.

4 The Inverted Brazilian Yield Curve



Source: Bloomberg, LPL Financial 06/17/11



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.

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