

Bond Market Perspectives

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What are Low Treasury Yields Telling Us?

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Highlights

The Fed's recent action adds to the list of why Treasury yields may remain low for the foreseeable future.

On the surface, low Treasury yields paint a very gloomy picture but unprecedented action by the Fed and events in Europe are blurring the interpretation.

Still the classic drivers of bond yields—growth, inflation, and the Fed—indicate high-quality bond yields will remain very low by historical comparison through year-end and into 2012.

Just when you thought Treasury yields could not go lower, Treasury yields finished last week lower still. The Fed's bold twist was the latest catalyst to send the 10-year Treasury yield further into record low territory while the 30-year Treasury bond yield fell within striking distance of its fall 2008 low. On the surface, low Treasury yields paint a very gloomy picture, but unprecedented action by the Fed and events in Europe are blurring the interpretation.

Although expected, the Fed's action, dubbed Operation Twist, was larger than anticipated and the latest catalyst to push yields lower. The \$400 billion in purchases that will be directed at Treasuries with a maturity of 6 to 30 years was at the high end of expectations. More importantly, the Fed announced that 29% of purchases will be directed towards 20- to 30-year maturity bonds, a much greater-than-expected emphasis on long-term bonds relative to intermediate maturity bonds.

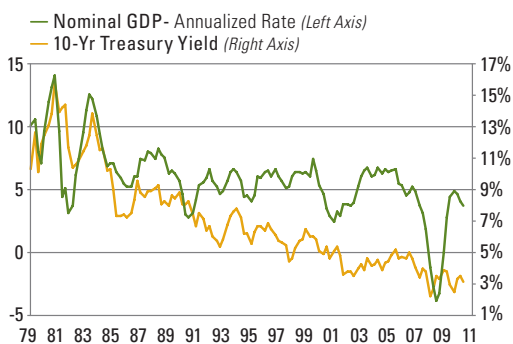
Operation Twist may provide initial support but by itself is not going to be a primary driver of bond prices and yields over the longer term. To understand what current Treasury yields tell us, we must decompose the classic, primary drivers of Treasury yields: economic expectations, Fed policy, and the level of inflation.

Economic Expectations

Perhaps most obvious, low Treasury yields are a reflection of the bond market predicting a recession or, at best, lethargic economic growth. Historically, intermediate- and long-term Treasury yields have been influenced by economic growth expectations [Chart 1]. The chart shows that bond yields and economic growth move in tandem. Bond yields move higher as economic growth expectations (and actual data) improve and vice versa. This makes intuitive sense as a stronger economy improves return prospects for a variety of investments and bond yields move higher to offer more compensation to investors. Strong economic growth also tends to generate inflation fears, which also work to pressure yields higher.

The chart also reveals however that since the late '90s the 10-year Treasury yield has decoupled and moved steadily lower for a given level of economic growth. Directionally, yields and economic growth move in tandem but the magnitude has diverged in recent years. The disparity suggests another factor is at work—namely, inflation.

1 Economic Growth Influences Bond Yields

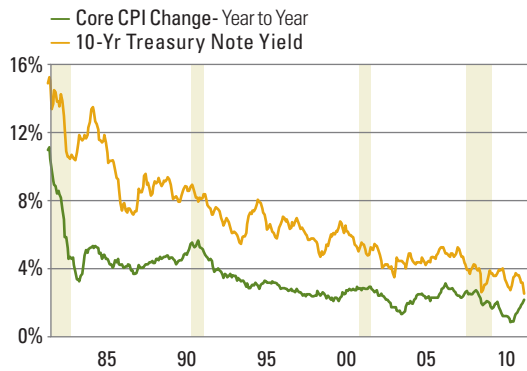


Source: Commerce Dept./Bloomberg/LPL Financial 9/23/11

Note the chart shows the year-over-year change in economic growth as measured by current dollar (not real, or inflation adjusted as is often quoted in the popular media) gross domestic product.



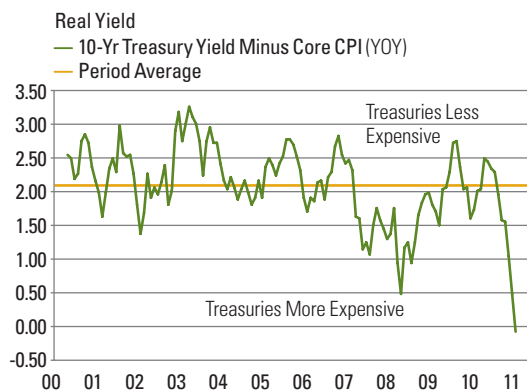
2 The 10-year Treasury Yield Provides Almost No Protection Against Inflation



Source: BLS/Federal Reserve Bank/Haver 9/23/11

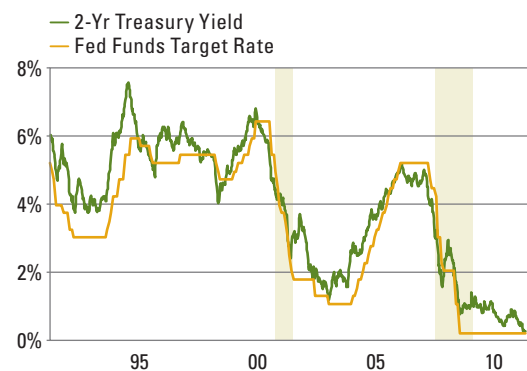
(Shaded areas indicate recession)

3 Treasury Valuations Are More Expensive Now Than in 2008



Source: Bloomberg/LPL Financial 9/26/11

4 The Fed is a Primary Driver of Bond Yields



Source: Treasury/Federal Reserve Bank/Haver 9/23/11

(Shaded areas indicate recession)

Inflation

Low Treasury yields suggest minimal inflation risk and perhaps a modest risk of deflation. In the late 1970s and early 1980s, bond investors demanded higher yields as compensation for higher inflation. Inflation ravaged bond investor returns in the 1970s and this painful memory remained in the back of investors' minds for years. Over time, the Fed broke the back of inflation, confidence in the Fed improved, and bond investors demanded less and less compensation for inflation risks. The extra yield, or premium, over the annualized rate of inflation has therefore declined [Chart 2]. In sum, yields have tended to stay lower even when economic growth surprises to the upside because investors have faith in the Fed to act decisively to thwart rising inflation. Other factors, such as globalization, have also worked to keep market inflation fears at bay but the Fed's credibility is the key driver.

However, current Treasury yields provide little to no protection against inflation (as Chart 2 also reveals) and indicates bond investors believe inflation will decelerate or, worse, perhaps turn into deflation—a prolonged period of falling prices and wages. We do not believe deflation is in the cards and we agree with consensus forecasts calling for a deceleration in inflation going forward, but for inflation to remain firmly positive over the remainder of 2011 and through 2012. Inflation-adjusted yields indicate Treasury valuations are more expensive now than during the peak of the financial crisis [Chart 3]. Chart 3 merely subtracts the rate of inflation in Chart 2 from the 10-year yield to show the inflation-adjusted yield, or real yield, a key valuation barometer.

The Fed

High valuations reveal the next key message from current bond yields: the Fed is your friend. At the conclusion of the August 2011 FOMC meeting, the Fed stated that interest rates would remain at currently low rates through June 2013. Historically, the Fed is one the primary drivers of bond yields since the Fed Funds Target Rate is highly correlated with short-term yields [Chart 4].

By promising to keep short-term interest rates on hold for nearly two years, the Fed has vastly reduced interest rate risk for bond investors. Therefore, the Fed's unprecedented step has thrown a kink into traditional bond valuation analysis and helped lead to more expensive Treasury valuations, as reflected in Chart 3.

Europe

Europe is the final piece of the puzzle in explaining the low level of Treasury yields. Although not as impactful as the three key drivers outlined previously, investment flows coming from Europe have played a secondary role. Concerns over the European debt problem and concerns over the financial health of European banks have caused Treasuries to gain a slight edge over German Bunds as the perceived safe-haven vehicle of choice among global investors. Recent precious metals weakness has provided additional support for Treasuries.



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Although the European debt problem is very serious, we do not believe it fully justifies such an expensive Treasury valuation. We certainly do not believe we are at the precipice of another 2008-like event. Banks, on balance, are far better capitalized, the use of leverage in the financial system is vastly reduced, and central banks around the globe have emergency lending facilities to act as safety nets.

A review of the classic drivers of bond yields, not just European related factors, is necessary to understand what Treasury yields are telling us. To be sure, the Treasury market has chosen a negative interpretation of economic growth and future inflation. However, the Fed, via its unconventional policy steps, most recently with Operation Twist, remains firmly the bondholder's friend by attempting to keep interest rates lower for longer. The Fed's actions have led to more expensive bond valuations and, along with a helping hand from European debt problems, perhaps a more negative implication than would otherwise be the case. We expect the 10-year Treasury yield to finish the year around 2.5% based upon our belief the economy avoids recession and economic fears abate. Looking out further, the classic drivers of bond yields suggest Treasury yields will remain low through 2012 represented by a 2.25% to 3.25% 10-year Treasury yield range.



IMPORTANT DISCLOSURES

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The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

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

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

Correlation is a statistical measure of how two securities move in relation to each other. Correlations are used in advanced portfolio management.

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.

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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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