

# Bond Market Perspectives



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## Summit Fever

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#### Highlights

Bond market swings on and around summits support our expectation for continued volatility in markets as outlined in our *2012 Market Outlook*.

An increasing number of summits reflect an escalating sense of urgency among European leaders to deliver more robust solutions to the European debt problem and one of the reasons we believe yield differentials between Treasuries and corporate bonds, both investment-grade and high-yield, will converge in 2012.

If there is one thing European leaders have been able to agree upon, despite their different cultures and languages, it is to agree to meet. Over the past two years the European Union (EU) Council, comprised of European heads of state such as Angela Merkel of Germany and Nicolas Sarkozy of France, have met 13 times. EU finance ministers, for whom the European debt problem initially fell harder, have met 24 times over the past two years. This week bond market focus will fall squarely on the EU Council's 8th meeting of 2011 to be held at the end of the week, December 9.

Several recent factors helped build optimism regarding this week's EU Summit and impacted bond market performance. On Monday, December 5, 2011, a pre-Council meeting between French President Sarkozy and German Chancellor Merkel suggested the two had reached a tentative agreement on changes to the EU Treaty: the topic for this week's EU Council meeting. Specifically EU leaders are seeking ways to modify existing laws that govern the European Union to better address the debt problem. The goal of treaty change is to allow for greater fiscal and economic unity similar to a "United States of Europe", where member countries would be held accountable for their fiscal health by a centralized body led by more fiscally sound countries such as Germany. Greater fiscal unity may open the door to a solution the market has been clamoring for—unleashing the financial firepower of the European Central Bank (ECB) to more aggressively combat the European debt problem. Last week, ECB President Mario Draghi indicated willingness for the ECB to do more should laws to more closely integrate the 17 countries sharing the euro currency be enacted.

But summit optimism was not the only factor that benefited corporate bond prices at the expense of Treasuries. Several positives drove improvement including:

- Central banks easing US dollar lending terms. Coordinated action by the Federal Reserve (Fed) and five other central banks announced December 1, 2011 should help ease inter-bank lending pressures. The Fed's move to lower the cost of borrowing dollars from global central banks by 0.5% should help cap inter-bank borrowing rates. The cost of funding, not the availability—as was the case in 2008—has been a problem for European banks.
- ECB lending to the International Monetary Fund (IMF). Since the ECB is restricted by EU Treaties from full-blown quantitative easing, such as the Fed's large-scale bond purchase programs, lending to the IMF would circumvent treaty restrictions and the enhanced IMF could more actively support troubled



Eurozone debt issuers. While this idea has been bandied about previously, more details emerged last week suggesting it remains an option.

- Prospects of an ECB rate cut. Consensus forecasts now call for a 0.25% rate cut at this week's ECB meeting, which would fully reverse the 0.50% worth of interest rate increases enacted earlier in 2011.
- Successful European government bond auctions. Despite mixed-results at Italian government bond auctions early in the week, good demand at government bond auctions in France, Spain, and Belgium helped boost investor sentiment.
- Bipartisan agreement to extend payroll tax holiday and unemployment benefits. It appears US politicians may finally be able to agree on something. Although an extension has not been finalized, the mere agreement to move forward with this stimulus is a positive for US economic growth in 2012.

News of the more robust approach toward the European debt situation was music to the ears of corporate bond investors. High-yield bonds returned 1.6% last week compared to a 0.3% loss for Treasuries (according to Barclay's High-Yield Bond Index data). More importantly, investment-grade corporate bonds in the financial sector posted an impressive 1.5% total return last week, nearly matching the return of lower rated high-yield bonds. This marked one of the strongest weekly performances of 2011. The momentum continued on Monday, December 05, 2011. The improvement in corporate bonds issued by banks and financial companies is a key market signal. Banks lie at the heart of financial markets and act like oil in the machinery of financial markets. Improvement in financial sector corporate bond prices is one of the most relevant signals that investors' view less risk in financial markets.

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On a cautionary note, the markets have exhibited excitement about summits before only to be disappointed with the results. In mid-September 2011, positive anticipation of an EU finance ministers meeting led to a decline in Treasury prices but the meeting concluded with no action taken. Similarly, Treasury prices weakened and yields increased in anticipation of the late October EU Summit and announcement of the Grand Plan. After both summits, Treasury prices increased and yields resumed their decline. It is no surprise that the rise in the 10-year Treasury yield last week was limited to just 0.1%.

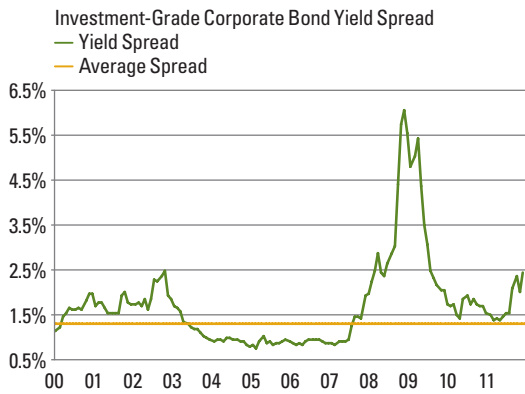
Summit fever will likely continue in 2012 and suggests that investor expectations will lead to volatile markets as outlined in our *2012 Outlook*. Should EU leaders fail to deliver adequate results this week, Treasuries may firm again and more economically sensitive bonds such as high-yield bonds, corporate bonds, and emerging market debt may give up some of their recent gains but we expect downside to be limited.

Over the past three-months, however, the sense of urgency appears to have increased among European leaders.

- New governments arrived in Italy, Spain, and Greece; central banks have reduced dollar funding costs

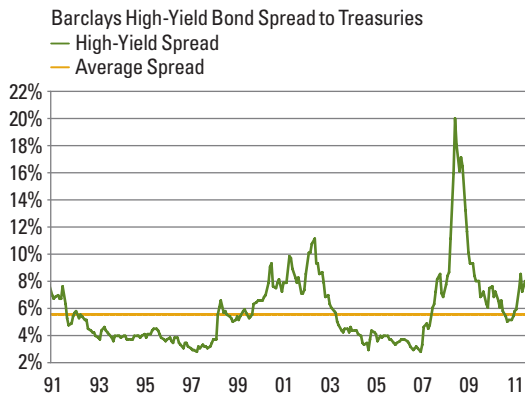


**1 We Expect Investment-Grade Corporate and...**



Source: Barclays, LPL Financial 12/02/11

**2 ...High-Yield Bond Yield Spreads to Converge Closer to Their Historic Averages in 2012**



Source: Barclays, LPL Financial 12/02/11

Past performance is no guarantee of future results.

- The ECB has (and will likely again) cut interest rates
- October’s Grand Plan produced a more detailed, robust approach to government budget deficits and debt burdens and now sets the stage for fiscal integration and a more aggressive ECB.

Ultimately, we expect European leaders to find a solution leading to a narrowing of yield differentials between Treasuries and corporate bonds. In the meantime, attractive valuations (as indicated in wider yield spreads—Charts 1 & 2) indicate corporate bond investors, both investment grade and high-yield, are paid to wait for improvement.

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

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

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