

Bond Market Perspectives



January 24, 2012

The Ides of January

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Highlights

The success of new lending facilities in Europe reversed some of the safe-haven buying of U.S. Treasuries and led to a weak start to the Treasury market so far in 2012.

Treasuries may remain under pressure, benefiting corporate bonds, as anticipation of the next European Central Bank (ECB) lending operation may keep positive momentum in place.

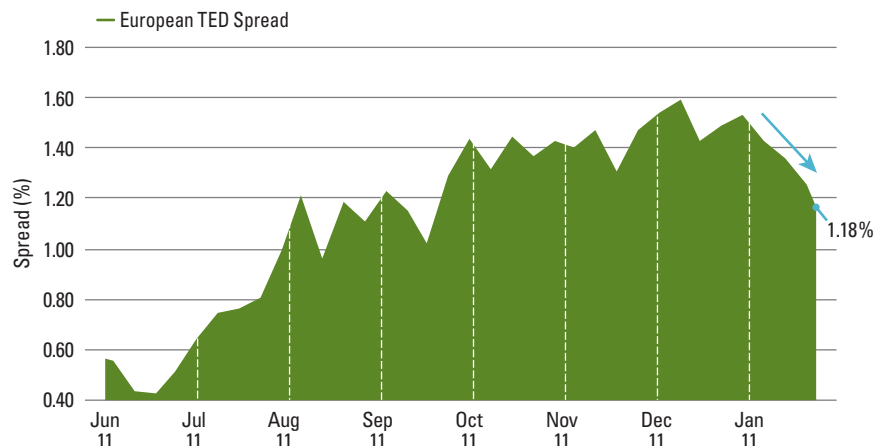
In ancient Rome, the “Ides” marked the middle days of every month of the Roman calendar. The Ides of March are most well-known, as it marks the assassination of Julius Caesar by a group of conspirators led by Brutus. The phrase became immortalized in Shakespeare’s play, *Julius Caesar*. Last week marked the middle of January and while far less dramatic than the fall of a Roman emperor, the last several days have proved a difficult time for the Treasury market. The 10-year Treasury yield increased by 0.2% over the last five trading sessions (ending Monday, January 23, 2012) and over the same period of time the 30-year Treasury bond declined by 4% in price (according to Bloomberg data). Both were rare shows of weakness from a Treasury market that has shown near invincibility over the past year.

The “Lead Conspirator”

The lead conspirator against the Treasury market proved to be the European Central Bank (ECB) and its new weapon, the 3-year lending facility launched in mid-December. The new, longer-term lending facility with its easier borrowing terms has proven more successful than anticipated. Several gauges of financial market stress in response to the European government debt overhang have shown notable improvement:

- **The European TED Spread:** The domestic version of this indicator proved to be a valuable measure of bank stress during the 2008 financial crisis.

1 Bank Funding Stress Has Receded Quickly In January



Source: Bloomberg, LPL Financial 01/23/12

The European TED Spread has contracted sharply in January reflecting **reduced borrowing strains** and therefore **less risk** in the European banking sector

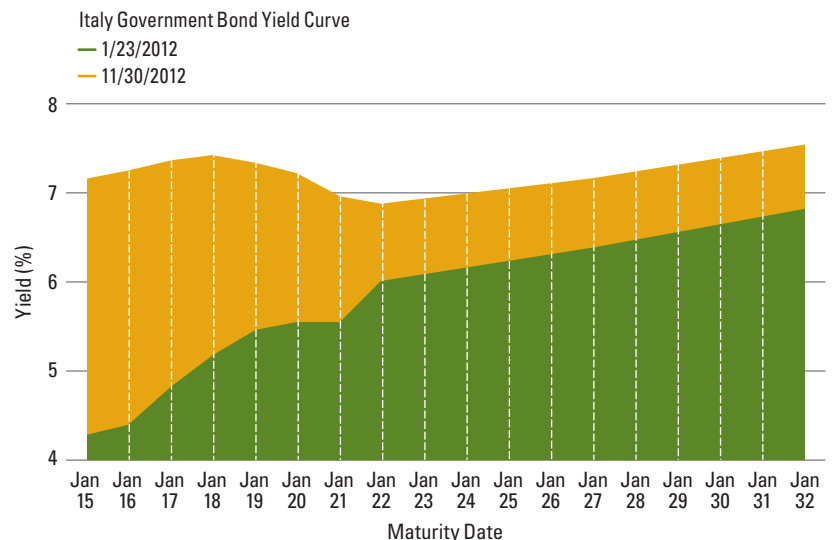


The European version measures the difference between 3-month Euribor, a Euro-based inter-bank lending rate, and German 3-month T-bill yields. This gauge has contracted sharply in January [Chart 1] reflecting reduced borrowing strains and therefore less risk in the European banking sector.

- Steeper Yield Curves:** In late November, a good portion of the Italian government bond yield curve [Chart 2] was flat-to-inverted as reflected by the high 3- to 10-year yields. However, note how short-term yields have collapsed sharply since then, and the Italian government bond yield curve now resembles a more normally functioning bond market. Under normal conditions, government bond yield curves are generally upward sloping (i.e., each successively longer maturity entails a higher yield to reflect the added potential interest and inflation risk). A yield curve can invert when investors believe a recession is forthcoming, but an inverted yield curve can also reflect default risk. High and rising short-term yields during periods of slow economic growth, as is currently the case in Europe, reflect bond investors pricing in a growing risk of near-term default. Many shorter-term European bank bonds also witnessed similar notable declines as the ECB's lending operation eased borrowing.

2 Italian Government Bond Yields Reflect Less Risk of Default

The Italian government bond yield curve now resembles a more **normally functioning** bond market; under normal conditions, government bond yield curves are generally **upward sloping**



Source: Bloomberg, LPL Financial 01/23/12

- Lower Credit Default Swaps (CDS) Spreads:** Similar to lower yields, the cost to insure the French, Italian, and Spanish government bonds against default, via CDS, declined sharply and now rests near a 5-month low. For example, the annual cost to insure Spanish government bonds against default over a 5-year time horizon declined from 4.9% to 3.5% (Bloomberg data). While this is still relatively high compared to the 0.5% it costs to insure Treasuries against default, it marks a significant improvement.



The “Co-Conspirators”

The ECB did not act alone and had co-conspirators against the Treasury market. China reported stronger-than-expected economic growth last week (January 16–20, 2012) that helped alleviate fears of a hard landing in China and reduce the safe-haven premium embedded in U.S. Treasury prices. In addition, China’s central bank gave China’s largest banks authority to increase bank lending, a sign that restrictive policies may be reversing, and raising hopes that more interest rate cuts may be coming in the weeks and months ahead. Domestically, the trend of good economic news continued with weekly jobless claims, an excellent leading indicator, falling to their lowest level since April 2008.

Of course, with the 10-year Treasury yield only marginally above 2.0%, it is difficult to call recent action a conspiracy or label the Treasury market as truly weak. The next European summit is January 30, and financial markets have typically been disappointed once summits come to a close. Failure by EU leaders to take additional steps forward may support Treasuries once again. A resolution between Greece and private bondholders also remains elusive. The risk of a disorderly default for Greece remains, even if small, as well as the uncertainty of what a resolution would entail for other European government bondholders. Both of these uncertainties may also support Treasuries. Finally, this week Ben Bernanke and the Federal Reserve (Fed) may outline new communications at the conclusion of the Federal Open Market Committee (FOMC) meeting to improve transparency and indicate that the Fed may remain on hold longer than the mid-2013 timeline. The revelation of an even friendlier Fed may give Treasuries a lift, but much of the Fed’s new initiatives are largely known.

What the Factors Behind the Ides of January Suggest

In the meantime, the success of the ECB’s actions may continue to pressure Treasuries and benefit corporate bonds, high-yield bonds, in particular. After all, recent improvement has only taken several key measures back to the best levels since September—still a weak period—suggesting there is more room for improvement. With another ECB 3-year lending operation just around the corner in February, positive momentum may build given the first operation’s success as investors line up for another dose of medicine. To be sure, the lending operation is not a long-term solution and just buys time for the European government and European banks to continue to address longer-term structural imbalances. For this reason, Treasury weakness is likely to be limited. A rise in the 10-year Treasury yield to the October high of 2.4% is possible, but we believe 2.2% is more likely to bring about renewed buying should weakness extend. As we have mentioned in prior commentaries, the 2.0% 10-year Treasury yield has acted as a center of gravity for the bond market since late August. Nonetheless, the confluence of factors behind the Ides of January—the ECB, China’s potential easing, and improving U.S. economic data—suggests improvement in more economically sensitive bonds, such as corporate bonds, emerging market debt, and preferred securities, may continue over the near-term. ■

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The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds 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 fund shares is not guaranteed and will fluctuate.

The TED Spread measures the difference between 3-month LIBOR rate and the yield on 3-month Treasury bills. This is an effective measure of the liquidity available to banks. With bank capital adequacy near the center of the current crisis this is an important gauge of the stress in the banking system. A rise in the TED Spread acts as a negative on the CCI.

Corporate Bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

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.

Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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