Bond Market Perspectives

October 21, 2014

Stay on Guard

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Highlights

Yields may remain low for evidence of any fallout or contagion to the U.S. economy; a stretch of stronger economic data or bolder action by overseas central banks are likely needed catalysts for higher yields.

The on-guard mentality in the bond market has pushed back timing for Federal Reserve interest rate hikes.

Although yields may stay pinned low for potential fallout from abroad, we still believe investors should stay on guard, with an emphasis on corporate sectors and a slight underweight to bonds.

The latest bout of risk aversion is keeping bond markets "on guard" for additional troubles and negative economic fallout that may keep yields low until proven otherwise by economic data or bold steps by some of the world's central banks. Europe remains on the brink of a recession and questions linger about the extent of the slowdown in China's economy. Along with slowing inflation in Europe, a stronger U.S. dollar, and lower energy costs, downward pressures on U.S. inflation may linger as well—and support bond prices in the process. Bonds may remain on guard, with prices range bound, through year-end 2014 and perhaps into 2015, waiting for potential contagion effects of dramatic economic slowing overseas. All of this suggests little impetus for yields to move significantly higher over the short term.

Bond yields may stay low even though the current move is extended by historical measure. As a percentage of the peak in yields—to account for the low yield environment—the yield decline over the past year amounts to slightly more than a 20% decline [Figure 1]. And using the 0.8% year-to-date decline amounts to a 26% change. Such extended moves are rare, but quick turnarounds are also rare, with mid-2005 as an exception. This suggests yields may stay low over the near term until a positive catalyst sparks a reversal.

1 The Decline in Yields Is Becoming Extended but Not Necessarily Due for a Turnaround

A	Recession	E	Financial Crisis
B	Greenspan Deflation Warning	F	European Debt Fears
C	Ford/GM Concerns	G	European Debt Fears 2
D	Rising Default Fears	H	Europe Deflation/Recession?

Source: LPL Financial Research, Bloomberg 10/17/14

Figure 1 also shows that a decline of 20% by itself may not stop the decline in yields, and they could fall further. We believe a new, lower yield range may be taking shape as defined by a 2.0% and 2.3% 10-year Treasury yield. After twice failing to break below 2.3% over the third quarter of 2014, the 10-year pushed through this resistance following the latest growth scare and stopped ahead of the psychological 2.0% yield barrier, which provides the next resistance, even though the 10-year Treasury yield dipped as low as 1.86% on an intraday basis very briefly on Wednesday, October 15, 2014.

Liquidity Risks

That sharp dip to 1.86% served as a reminder of liquidity risks (the ease with which an investment can be bought or sold). At the time, the drop to 1.86% amounted to a 0.34% yield change for the day — the greatest daily change since fall 2008 and the financial crisis. Ultimately the move was quickly reversed, but nonetheless grabbed investors' attention as such volatility is extremely rare for the Treasury market. The sharp move lower in yields was likely driven by large investors forced to cover short positions. That a presumably few, but large, trades could have such an impact raises questions about whether it could happen again. Treasury volume was well above average last week but reflects the breadth, although not necessarily the depth, of the market. Uncertainty over whether more offside investors may be forced to exit positions is another reason that yields may hold near recent lows.

Signs of an illiquid market were prevalent in corporate bonds markets. Both investment-grade and high-yield bonds saw the fewest trades since December of last year. According to FINRA trade reporting, both investment-grade and high-yield bonds witnessed trading levels commensurate with the year-end holiday season, far from normal trading levels. Dodd-Frank financial regulatory reform has discouraged bond dealers from holding bonds in inventory to facilitate trading. The reduced liquidity can exacerbate price swings in either direction. In 2013, poor liquidity fueled the rise in rates; the opposite is occurring in 2014.

Fed Expectations

The on-guard mentality in the bond market has pushed back timing of Federal Reserve (Fed) interest rate hikes.

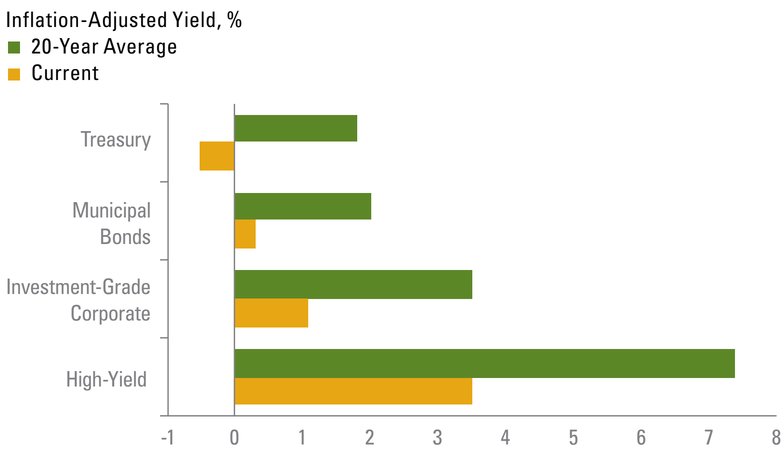
The on-guard mentality in the bond market has pushed back timing of Federal Reserve (Fed) interest rate hikes. Rate hike expectations fell sharply last week as overseas growth fears and low inflation — which will likely remain low following the recent decline in energy prices — prompted investors to expect the Fed to stay on the sideline for most of 2015 or risk a global recession if it raises interest rates too soon. Recent comments from Dallas Fed President Fisher, a noted inflation hawk and one who has disagreed with the Fed's easy monetary policy in the past, appeared to change his tune just over one week ago, suggesting that U.S. dollar strength and European economic weakness may cause the Fed to remain on hold for longer.

Staying Defensive

The investment challenge facing bond investors does not necessarily change, even with a greater likelihood of yields staying near current lows.

The investment challenge facing bond investors does not necessarily change, even with a greater likelihood of yields staying near current lows. Across the bond market, inflation-adjusted, or real, yields remain far below historical norms as a reflection of just how expensive bonds are [Figure 2]. Real yields do not take into account varying amounts of interest rate risk or default risk, which can influence overall yield levels. However, should the economy remain resilient, as it has during prior bouts of European growth fears, then the higher real yields of the corporate sector may provide bond investors better opportunity.

2 Real Yields Reflect Expensive Valuations Across the Bond Market



Source: LPL Financial Research, Bloomberg, Barclays Index data 10/20/14

An allocation to high-quality bonds can still help protect against additional stock market declines, but we continue to favor corporate sectors as a means to seek out better valuations.

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.

Since the end of the global financial crisis, Europe re-entered recession once and did not pull the U.S. economy down with it. Bouts of European debt fears have contributed to Treasury strength but not a renewed recession in the United States. The preponderance of data suggest the U.S. economy will pass this latest growth scare, but yields may remain low in the meantime. On a positive note, the recent drop in gasoline prices should help support consumer spending and provide support to the economy. Although yields may stay pinned low for potential fallout from abroad, we still believe investors should stay on guard, with an emphasis on corporate sectors and a slight underweight to bonds. ■

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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.

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