Bond Market Perspectives

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Growth Signals

Anthony Valeri, CFA
Fixed Income & Investment Strategist
LPL Financial

Highlights

The combination of additional cuts to overnight borrowing rates and the announcement of the ABS purchase program was slightly more than expected from the ECB.

Bond markets sent growth signals in response to ECB action in the form of higher yields, higher inflation expectations, and a steeper yield curve.

Global bond markets sent growth signals for the second consecutive week following action from the European Central Bank (ECB) to boost Eurozone economic growth. The ECB appears set to take a page from the playbook of the U.S. Federal Reserve (Fed) and the Bank of Japan by announcing its first version of a bond purchase program, known as quantitative easing (QE). Although the ECB has engaged in numerous lending programs to Euro-area banks, this is the first bond purchase program without offsetting sales. The ECB will buy asset-backed securities (ABS) in an attempt to boost consumer borrowing and economic growth.

The combination of additional cuts to overnight borrowing rates and the announcement of the ABS purchase program was slightly more than expected from the ECB and led to lower bond prices and higher yields globally. It was the second consecutive down week for global government bond prices after ECB President Mario Draghi hinted strongly at bond purchases during the Fed's annual Jackson Hole conference in late August.

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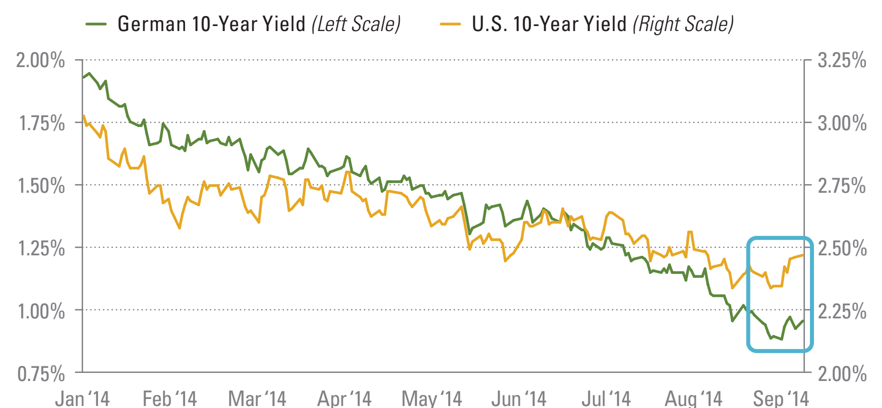
Global bonds sent growth signals in the form of:

- **Higher yields.** Intermediate- to long-term yields in the United States and Germany increased following Draghi's comments and continued to rise as the ECB followed through on the strong rhetoric with additional rate cuts and the ABS purchase program [Figure 1]. A weaker-than-expected monthly U.S. jobs report (for August) pushed bond prices higher late in the week but not enough to offset earlier weakness in response to the ECB action.

1 ECB Action Pushed Bond Yields Higher Globally

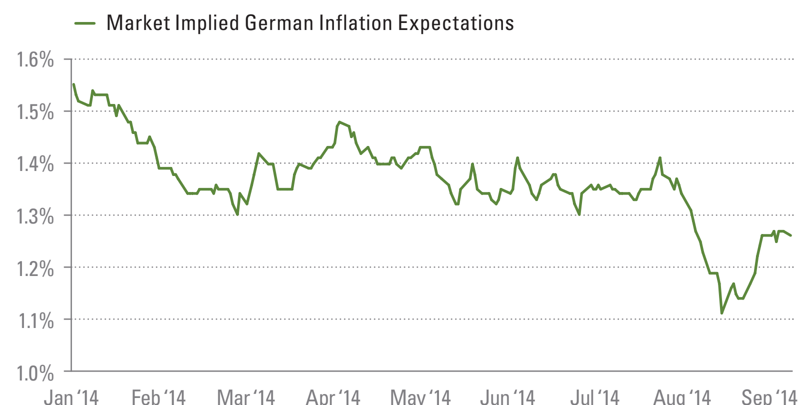


Source: LPL Financial Research, Bloomberg 09/08/14

Past performance is no guarantee of future results.

- **Higher inflation expectations.** Inflation expectations, as measured by German inflation-protected bonds, increased for the second consecutive week [Figure 2]. If the ECB aims to ward off deflation risks, a key first step is to boost investors' inflation expectations. On this note, the ECB may be pleased by the early reaction. A similar increase in inflation expectations occurred among U.S. Treasury Inflation-Protected Securities (TIPS).

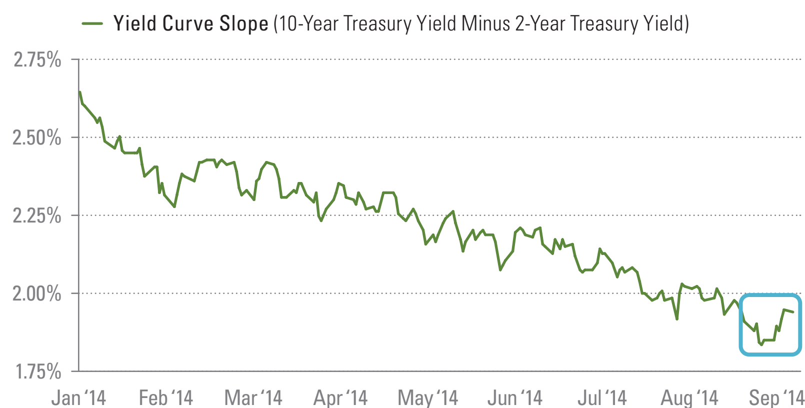
2 Inflation Expectations Bounced Following the ECB Meeting



Source: LPL Financial Research, Bloomberg 09/08/14

- **Steeper yield curve.** The yield differential between short- and longer-term bonds increased for the second straight week, leading to a "steeper" yield curve—a classic growth signal [Figure 3]. Higher longer-term bond yields reflect better future economic growth expectations.

3 The Yield Curve Steepened to Reflect Higher Growth and Inflation Expectations



Source: LPL Financial Research, Bloomberg 09/08/14

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Still Early

All three figures illustrate that although the moves are corroborated across various market measures, changes in response to the ECB are still modest thus far. Bond investors are likely unconvinced that the ECB's latest steps

may benefit the Eurozone economies enough to warrant substantially higher yields. Additionally, the lack of details on the ECB's ABS purchase also raises uncertainty about the potential impact. So far, Draghi and company are likely pleased by the market's response, which is similar to Treasury reaction following the Fed's QE1 and QE2 programs. But follow-through is needed to keep the bond market showing growth signals; otherwise, bond weakness may subside and follow the limited short-term reaction that followed the Fed's Operation Twist and QE3.

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At a minimum, ECB action appears to have halted the advance of European bond markets for now—a key driver of U.S. bond market strength in 2014. In the current week, U.S. bond markets will take their cues from auctions of 3-, 10-, and 30-year Treasury securities (September 9–11, 2014) in the absence of significant economic data. As usual, the sale of more interest rate–sensitive securities, such as the 10- and 30-year, will provide a good gauge of investor demand.

Bond weakness was fairly broad based last week as investors rebuked bonds in the aftermath of the ECB news. Since the Jackson Hole conference, more credit-sensitive sectors have outperformed within the bond market. A soft jobs report was downplayed following strong reports from both the manufacturing and service sector Institute for Supply Management surveys for August. After this week's Treasury auctions, the Fed meeting concluding in just over a week's time, on September 17, 2014, will fill in the next key piece of the central bank puzzle. Following a strong start to 2014, higher valuations, and better economic growth, we still believe investors should maintain a cautious approach with a mix of short and intermediate bonds along with an emphasis on economically sensitive (less interest rate–sensitive) fixed income sectors. ■

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