LPL RESEARCH
BOND MARKET PERSPECTIVES

January 27 2015

ALL ABOUT THE CENTRAL BANK(S)

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KEY TAKEAWAYS

Recent central bank action has reinforced the "lower for longer" interest rate theme in global bond markets.

This week's Fed meeting may temper market-friendly central bank trends, but seems unlikely to alter the current environment.

Higher-yielding sectors, such as high-yield bonds and emerging markets debt, may benefit from the ECB's bold purchase plan, while high-quality bond yields will potentially remain in a lower range for longer.

Global central banks continue to do their part in reinforcing the "lower for longer" interest rate theme in global bond markets. The European Central Bank (ECB) followed through with its own outright bond purchase program known as quantitative easing (QE) last Thursday, January 22, 2015. The ECB positively surprised investors with a greater than expected €1.1 trillion purchase program, including longer 30-year debt among its purchases, and stated that purchases will continue "until at least September 2016." The open-ended commitment underscored the ECB's resolve to spark economic growth and higher inflation.

The ECB got the response it wanted, at least initially, as bond prices broadly increased, inflation expectations rose, and the euro currency weakened. The response from global bonds was similar, with longer-term bond yields falling, although to a lesser magnitude than witnessed in Europe.

The ECB was not alone in supporting the "lower for longer" theme as central banks from Switzerland, Canada, Denmark, Romania, India, and Turkey all lowered interest rates in the days leading up to the ECB meeting. The Swiss National Bank's cut of overnight lending rates further into negative territory to -0.75% foreshadowed the ECB move, and the Danish central bank cut interest rates twice, the second cut coming just after the ECB's announcement.

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FED FOCUS

A rate cut, or even a hint of one, is certainly not expected at this week's Federal Reserve (Fed) meeting; however, the Fed's statement will be closely dissected for any change in sentiment with regard to timing of a first interest rate hike. Will the Fed heed the trend of other global central banks or march to the beat of its own drum? Key focal points for investors will be:

- **"Patient" versus "considerable time."** In the past, removal of the "considerable time" language has signified a rate increase in approximately six months, but at its December meeting, the Fed chose to include both "patient"

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and "considerable time." Fed Chair Yellen has defined "patient" as "at least two meetings," suggesting that removal of "considerable time" in this week's Fed meeting would keep the possibility of a June 2015 first rate hike. Sole use of "patient" would rule out subsequent Fed meetings in March and April.

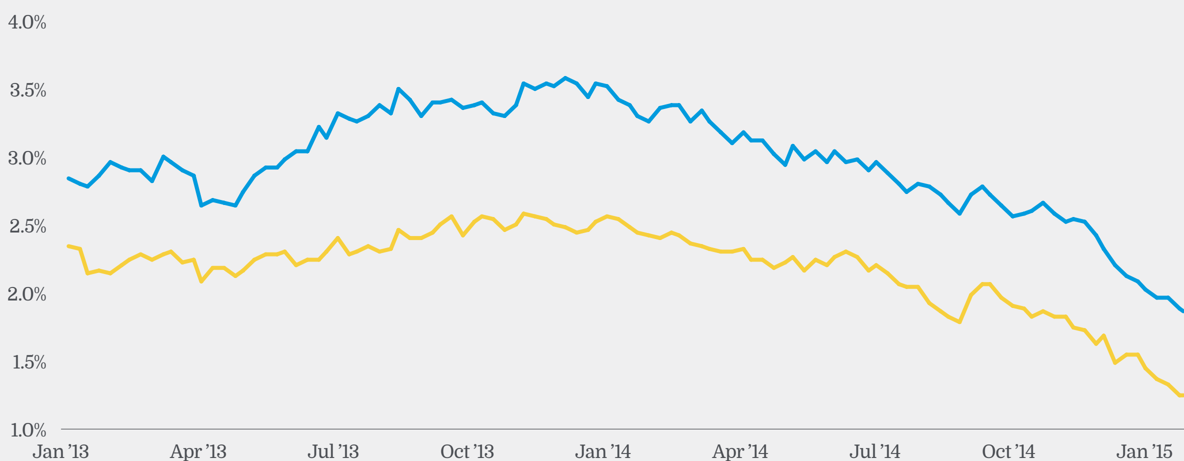
- **Assessment of lower inflation.** So far the Fed has downplayed lower inflation readings as transitory, but since the last Fed meeting, December Consumer Price Index (CPI) inflation readings (released on January 16, 2015) were weaker than expected. With actual inflation measures decelerating and core inflation measures well below the Fed's 2% target—and likely to remain low over the near term due to the stronger dollar and sharp decline in oil prices—the Fed will have a tougher time justifying a near-term rate hike. Additionally, market-based inflation expectations (as measured by Treasury Inflation-Protected Securities) are now lower compared with when the Fed last met in mid-December 2014.

The Fed's statement will be all investors have to digest. This Fed meeting is not followed by a press conference or an update to the Fed's strategic economic projections. The Fed may very well play it safe and not make many wording changes and instead, wait until Yellen's semiannual testimony to Congress (typically held in mid- to late February) before trying to communicate any more substantive views on Fed rate hike timing.

EFFECTS OF ECB ACTIONS

Global bond yield curves have flattened in response to the ECB, Bank of Japan, and other banks that have taken more bond market–friendly policy stances [Figure 1]. The ECB's action last week may lead to additional flattening, as investors migrate out of short-term bonds and into higher-yielding longer-term bonds. Although longer-term bond yields are near record historic lows, ECB actions incentivize investors to seek extra yield in longer-term debt.

1 ECB QE LED TO MORE YIELD CURVE FLATTENING



Source: LPL Financial Research, Bloomberg 01/26/15

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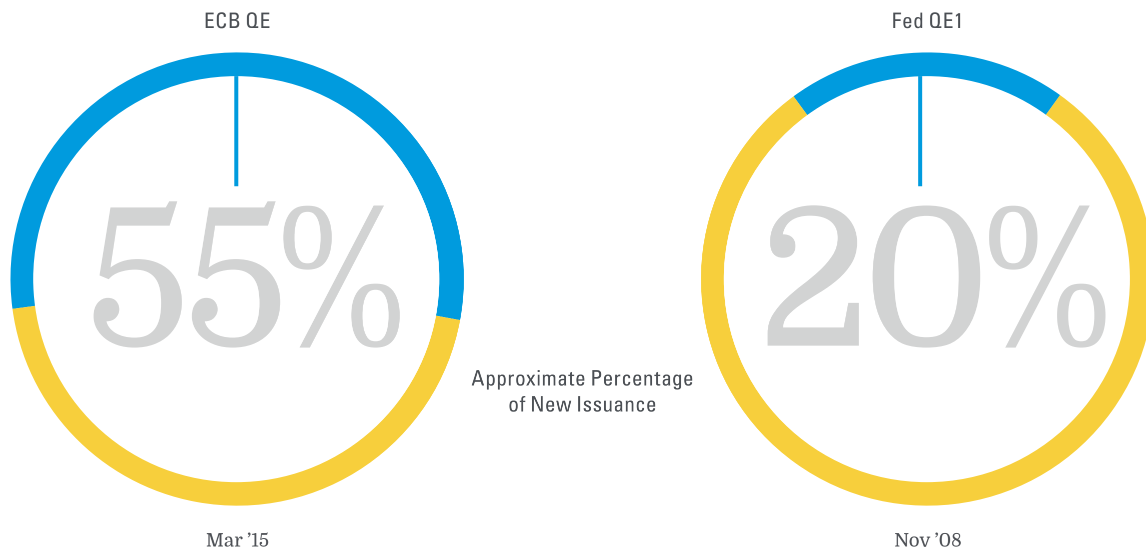
The extent of ECB bond purchases is different compared with the Fed's first salvo of QE, and may give the flattening trend more legs. Relative to the size of the Eurozone economy, the ECB's announced bond purchases are slightly less compared with the Fed's QE1, relative to the U.S. economy. However, since the Eurozone has a smaller relative bond market than that of the U.S., ECB purchases may have a greater market impact [Figure 2]. Compared with the Fed's QE1 purchases of Treasuries and mortgage-backed securities, the ECB will be buying a greater share of projected new government and corporate bond issuance, and therefore, create a greater supply-demand imbalance that could keep yields lower for longer.

A corollary to the flatting of government bond yield curves is that the search for yield will extend to corporate bond markets. In Europe, both investment-grade and high-yield corporate bonds have been strong beneficiaries. The U.S. high-yield bond market, on the other hand, has witnessed only a slight lift from ECB action but has helped provide a stabilizing force just the same.

Absent signs of a recession, which we do not expect, both high-yield bonds and emerging markets debt (EMD) may be beneficiaries of the recent ECB move, as investors seek out higher-yield debt securities. In the United States, uncertainty over the impact of lower oil on the

2 ECB PURCHASES MAY HAVE A GREATER MARKET IMPACT



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Source: LPL Financial Research, SFIMA, Federal Reserve, Bloomberg 01/26/15

Note: Percentages based upon projected Eurozone issuance of government and corporate bonds for 2015. QE1 comparison to issuance of Treasuries and mortgage-backed securities in 2009.

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energy sector may limit gains, but an average yield of 6.5% (using the Barclays High Yield Index) is compelling in a low-return world.

EMD may benefit as investors seek out the highest-yielding short-term bonds. With global central banks cutting overnight lending rates, investors may gravitate to government bonds with higher short-term rates, most of which reside in EM countries. Bonds denominated in local currencies offer higher yields, due to the added currency risk, and can help offset weakness should U.S. dollar strength continue. As the ECB fills the void left by the Fed, EMD may be supported and benefit from continued strong demand for higher-yielding assets.

Economic weakness, a recession, or an increase in defaults would be risks to each asset class above, of course. Clarity on both may take months to unfold. Meanwhile, investors are paid to wait.

CONCLUSION

Although we expect stronger U.S. growth and eventual Fed rate hikes to push bond yields higher in 2015, recent ECB action reinforces the current low level of interest rates over the near term. This week's Fed meeting may temper enthusiasm for high-quality bonds, but that seems unlikely with Fed Chair Yellen's congressional testimony just around the corner. The "lower for longer" theme may spark renewed demand for high-yield bonds and EMD. ■

IMPORTANT DISCLOSURES

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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 fund shares is not guaranteed and will fluctuate.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market, and interest rate risk.

INDEX DESCRIPTIONS

The Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging markets debt.

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