Bond Market Perspectives

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European Influence

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Highlights

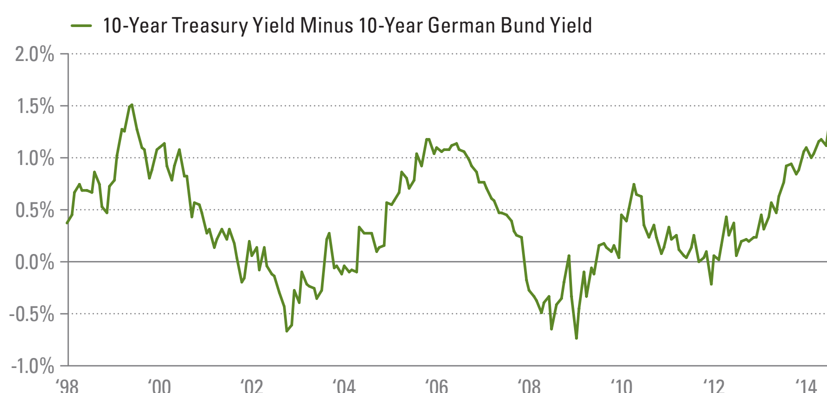
The strength of European government bonds has supported demand for US Treasuries due to more attractive yield differentials.

European influences may continue over the near term, but we expect U.S. bond yields to reconnect to domestic economic data in coming months.

Europe's influence over the domestic bond market looks set to continue over the near term. Throughout 2014, lower yields among European government bonds have made US Treasury yields look attractive by comparison. More favorable yield differentials have drawn global investors to US Treasuries and played an important role in domestic bond market strength this year.

The yield advantage of intermediate US Treasuries relative to German government bonds is near a 15-year high [Figure 1]. The German 10-year Bund yield dropped to an all-time low of 1.04% last week in response to weaker European economic data. German government bond strength supported U.S. government bonds and, in turn, the broad high-quality domestic bond market. German factory orders and industrial production were weaker than expected, and Italy's economy unexpectedly contracted during the second quarter. The poor European economic data raises concerns about another recession in Europe and what could be Italy's third recession in the past five years.

1 The Yield Advantage of Treasuries Relative to German Government Bonds Is Near a 15-Year High



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

Past performance is no guarantee of future results.

Geopolitics and Sanctions

Weaker economic data also raised fears that Russian sanctions may be taking a toll on the European economy. European economies are more

connected to the Russian economy than other developed markets. Russia's recent retaliatory sanctions on agricultural imports will have almost no impact on the United States, since exports to Russia comprise only a small fraction of domestic economic growth, as measured by gross domestic product (GDP). The impact, however, is greater for Europe. Concerns that sanctions may be a broader drag on economic growth, or escalate further, have supported top-quality European government bonds.

The threat of geopolitical tensions lingering bolstered high-quality bond demand globally. Uncertainty over how long Ukraine-Russia tensions will persist, as well as renewed strikes in Iraq, aided bond markets. In low-volume summer months, such as August, demand for high-quality liquid assets is often higher than normal, but global events likely bolstered this demand.

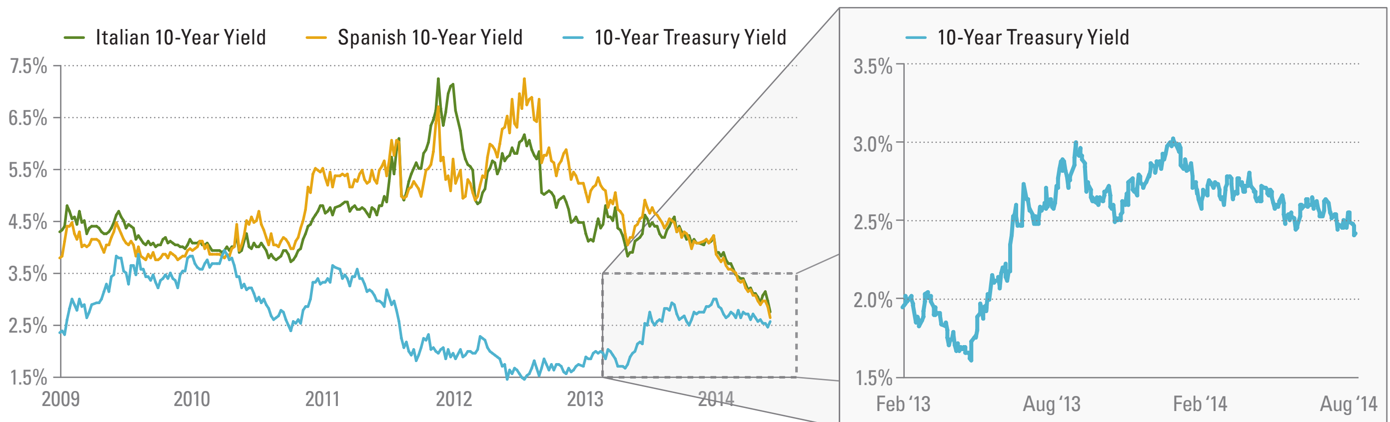
Central Banks on Different Paths

The yield advantage of 10-year Spanish and Italian government bonds to the 10-year Treasury has narrowed to less than 0.5% from a peak of over 4.0%.

The differing paths of central bank policies, which appear likely to persist over the near term, are another driver keeping European government bond yields low relative to Treasuries. The European Central Bank (ECB) cut interest rates earlier this year and remains committed to increasing stimulus while the Federal Reserve (Fed) is slowly moving toward an interest rate hike. The ECB may launch its version of bond purchases, similar to the Fed's actions, this fall, while the Fed is expected to finish bond purchases, known as quantitative easing (QE), at the same time.

The different approaches of the ECB and Fed are a primary reason why the yield differential between Spanish and Italian government bonds has converged to US Treasuries [Figure 2]. ECB lending programs, interest rate cuts, and ECB President Mario Draghi's comments to do "whatever it takes" have bolstered confidence in peripheral European debt issuers such as Italy and Spain. Supported by better global economic growth over recent years, the yield advantage of 10-year Spanish and Italian government bonds to the 10-year Treasury has narrowed to less than 0.5% from a peak of over 4.0%.

2 Spanish and Italian Government Yields Have Converged With Treasuries, and Treasuries Have Dropped Below the Bottom of the One-Year Yield Range



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

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Spanish and Italian government bond yields increased last week in response to the economic impact, which resulted from sanctions (and whether sanctions may escalate further), the threat of geopolitical tensions, which lingered for longer than anticipated, and weaker economic data. US Treasuries were a beneficiary, with both the 10-year and 30-year Treasury yield dropping to new year-to-date lows. The 10-year Treasury yield broke below 2.45% — the low end of a yield range that persisted for the past year [Figure 2]. The breach of this long-standing yield barrier could usher in additional near-term strength.

Not Worth Chasing

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European events and government bond yields may continue to support US Treasuries over the near term, but we would not use recent strength to add to high-quality bonds. After pausing in June and July, the resumption of Treasury strength has made valuations more expensive and the longer-term investing prospects less appealing. While high-quality bonds should comprise an allocation in diversified portfolios, recent Treasury strength also comes in the face of stronger domestic economic data. Last week, the Institute for Supply Management's (ISM) non-manufacturing survey was stronger than expected and weekly jobless claims dropped to new multi-year lows, boding well for further strength in the monthly jobs report. Both reports added to evidence that the U.S. economy is back on track with a 3%-plus growth rate.

We find long-term investing prospects of top-quality bonds unattractive and recommend a cautious posture with a mix of short and intermediate bonds.

New supply in the form of 3-, 10-, and 30-year Treasury sales beginning Tuesday, August 11 may slow the advance of Treasuries, but global risks may keep demand elevated over August as investors emphasize safety and liquidity during low-volume summer trading. While the risk of higher bond yields and lower prices may have passed over the short term, we find long-term investing prospects of top-quality bonds unattractive and recommend a cautious posture with a mix of short and intermediate bonds. ■

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