Bond Market Perspectives

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Breaking Up

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Highlights

The Fed will end outright bond purchases this week, barring any surprises from this week's Fed meeting.

The end of bond purchases should not create much market reaction, as bond investors focus more on global economic growth and expectations for interest rate hikes.

The Fed's breakup will not be a clean one as it maintains a steady influence in the MBS market.

Ending any relationship is difficult. Ideally a breakup is amicable, but often the result is acrimonious. Avoiding a harsh or violent reaction is best—but not always achieved. The bond market will say goodbye once again to Federal Reserve (Fed) Treasury purchases in another breakup in this on-again, off-again relationship of the past six years. The last outright Treasury purchase concluded Monday, October 27, 2014, as the Fed purchased nearly $1 billion of long-term Treasuries. Unless the Fed announces an extension at the conclusion of this week's policy meeting, the Treasury purchase program is officially over. An extension appears highly unlikely given the improvement in the jobs market and the overall economy over the past six months, which may be confirmed by the forthcoming preliminary reading of third quarter economic growth.

Assessing Possible Bond Reaction

This is arguably the most widely anticipated policy conclusion in the Fed's history, suggesting that the end of bond purchases may not create much market reaction. Since announcing a tapering of bond purchases in

1 Bond Reaction to the Start or End of Fed Purchases Has Become More Muted over Time

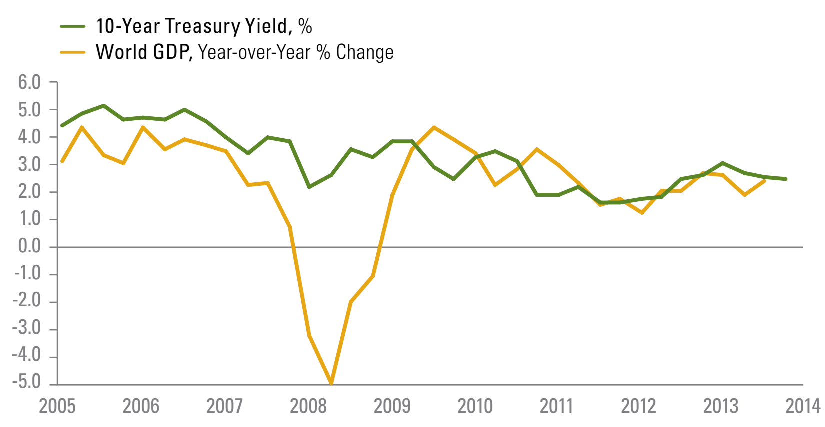
Source: LPL Financial Research, Federal Reserve 10/27/14

December 2013, the Fed has steadily reduced bond purchases over 2014. Bonds closed higher on Monday, October 27, 2014, showing that the lack of a major buyer is not a concern.

In the past, the end of Fed bond purchases programs, known as quantitative easing (QE), has led to lower bond yields—a somewhat counterintuitive result. But over the years, reaction to the end of subsequent purchase programs has become muted, with the end of Operation Twist and start of QE3 provoking a limited reaction [Figure 1]. In the latter cases, the economy had improved to the point where investors were less fearful of the economy's ability to stand on its own without Fed assistance. The sharp drop in bond yields during the summer of 2011 was due in large part to the Fed's announcement that would remain on hold for nearly two years, reducing a key source of interest rate risk at the time.

Therefore, the end of tapering is just a distraction from one of the two primary drivers of bond yields—global economic growth. In an increasingly connected global financial market, U.S. bond yields are more sensitive to the global economic environment. The fall in European bond yields and the pull on U.S. Treasury yields are examples of the growing interconnectedness. The correlation between global economic growth and bond yield is easily visible [Figure 2]. Although the paths can deviate over the short term, the deceleration in global growth, due in large part to weakness in Europe and a slowdown in China, has helped pressure yields lower in 2014. The International Monetary Fund's (IMF) recently reduced global growth forecast for 2014 has reinforced focus on worldwide economic growth.

2 Bond Yields Will Focus on Global Economic Growth…

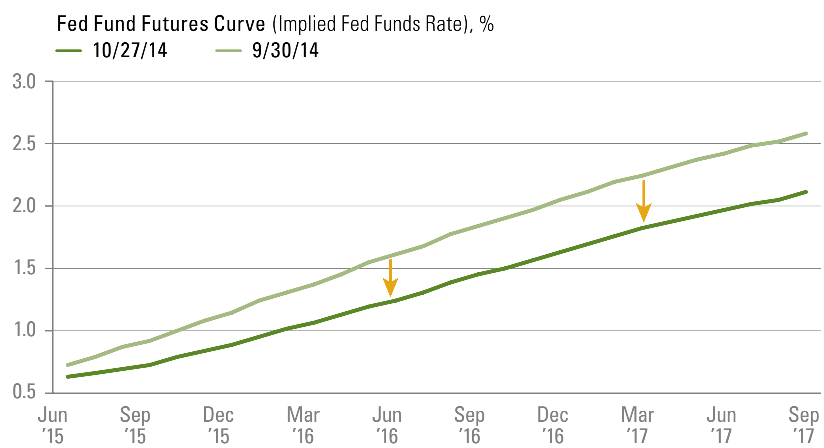


Source: LPL Financial Research, Bloomberg 10/27/14

Past performance is not indicative of future results.

Expectations around the timing of Fed interest rate hikes are the other primary driver of bond yields. In recent weeks, bond investors have dramatically scaled back their expectations [Figure 3], providing additional support for bonds. The Fed's first rate hike is now priced in just before the end of 2015, pushed back from a mid-2015 expectation. Expected changes in short-term rates, along with economic growth expectations, are likely to maintain a greater influence over bond yields than the quantity of bonds the Fed is purchasing.

3 …And Expectations for Interest Rate Hikes



Source: LPL Financial Research, Bloomberg 10/27/14

Keeping Strings Attached

The Fed will buy nearly $5 billion of MBS this week, ending QE3. But it will continue to reinvest proceeds from existing MBS holdings, which amounts to roughly $20 billion per month in purchases.

The Fed will keep some strings attached via the mortgage-backed securities (MBS) market. The Fed will buy nearly $5 billion of MBS this week and conclude purchases Friday, officially bringing QE3 to a close. However, the Fed will continue to reinvest proceeds from existing MBS holdings, which amounts to roughly $20 billion per month in purchases—a significant quantity. Because new mortgage origination has been lackluster in 2014, the Fed's monthly reinvestment purchases will keep the supply of MBS somewhat limited. MBS yield spreads may remain narrow and keep MBS valuations on the expensive side of historical norms.

The Fed's breakup will not be a clean one as it maintains a steady influence in the MBS market. Absent any surprises at this week's Fed meeting (which we do not expect), bond prices will continue to focus on economic growth and the prospect of future interest rate hikes. The end of bond purchases has been widely anticipated for some time. Uncertainty over the extent of weakness in European economies, the strength of the U.S. dollar, lower energy prices, and how all three may keep inflation low and growth subdued may likely keep bond prices range bound at the current lower yield range. ■

IMPORTANT DISCLOSURES

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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.

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.

Mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

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