Bond Market Perspectives

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Central Bank World Cup

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Highlights

Strong economic data has weighed on bonds to start June but favorable yield differentials between Treasuries and European government bonds have helped limit the domestic bond weakness.

Divergent central bank policies may still mean bonds yield to growth.

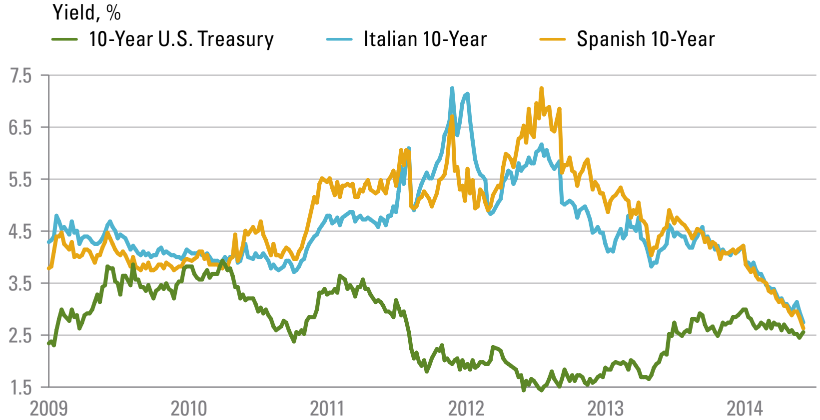
The World Cup kicks off this week in Brazil and teams from around the globe will showcase their unique style and strategy. Historically, the free-flowing "beautiful game" style of Brazil, for example, contrasts with the more structured strategies of European squads. But strategies appear to be melding globally as players and coaches bring overseas experience back home to their national teams.

Geography influenced bond markets last week as central bank strategies can influence bond markets across the globe. Strong U.S. economic data, including solid job gains in May, improvement in the Institute for Supply Management (ISM) manufacturing survey, and robust auto sales helped push bond prices lower and yields higher as investors reacted to additional signs of the economy rebounding from its winter slump.

ECB on the Offensive

The impact on U.S. bonds was only modest, however, as action from the European Central Bank (ECB) influenced bond prices. The ECB announced additional stimulus measures, including rate cuts and additional lending

1 10-Year Spanish and Italian Government Bond Yields Are Now Similar to Comparable Treasury Yields



Source: LPL Financial Research, Bloomberg 06/10/14

Past performance is no guarantee of future results. One cannot invest directly in an index.

facilities, to help boost lackluster European growth, sparking a strong bond rally among many European government bonds in the process.

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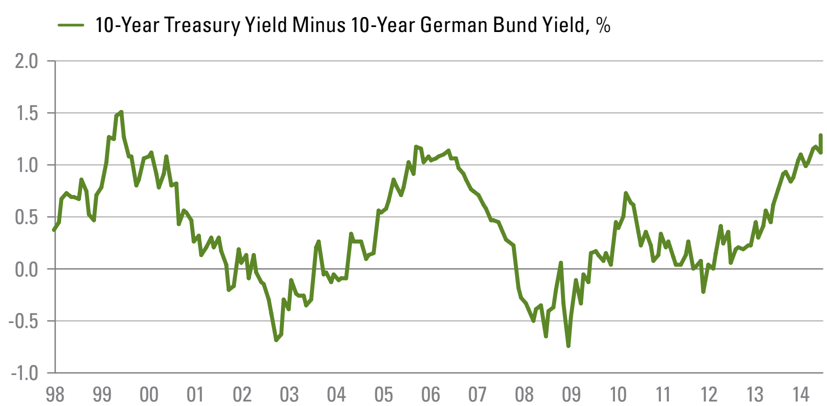
European government bonds responded to ECB action similar to how U.S. Treasuries responded in the past in the wake of bold stimulus from the Federal Reserve (Fed). Top-quality German government bond prices decreased while formerly troubled European peripheral bond issuers such as Spain, Italy, Portugal, and Greece witnessed powerful gains as did European corporate bonds. In sum, more economically sensitive bond segments benefited most from the ECB. Yields on 10-year Spanish government bonds, which are rated Baa2/BBB (by Moody's and S&P, respectively) fell below that of 10-year U.S. Treasuries as yield differentials continued to collapse [Figure 1]. Five-year yields of both Spain and Italy are below that of Treasuries, reflecting divergent growth and central bank regimes.

The credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade.

U.S. bonds began June on a weak note, but the narrowing yield differential between Treasuries and peripheral European government bonds has helped support Treasury prices in the face of stronger economic data. Among top-quality European government bonds, a substantial yield advantage to German Bunds also helped limit Treasury weakness. The 10-year Treasury yields 1.25% more than the comparable 10-year German Bund, the largest yield advantage in 15 years [Figure 2].

2 The Widest Yield Advantage in 15 Years Helped Limit Treasury Weakness So Far in June



Source: LPL Financial Research, Bloomberg 06/10/14

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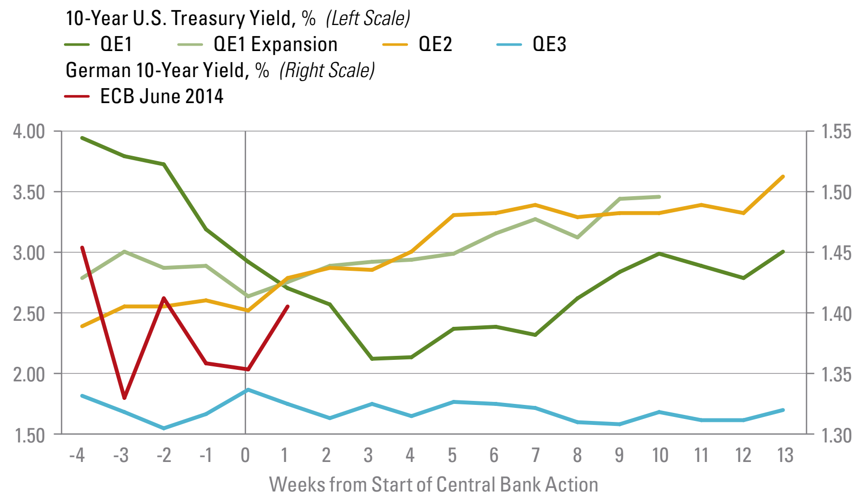
The limited rise in German government bond yields thus far suggests that the bond market remains skeptical of the beneficial impact the ECB's actions may ultimately have on the Eurozone economy. However, it may have halted the German bond rally and, if the ECB follows through with outright bond purchases (as it suggested it is likely to do at an upcoming meeting), German bond yields may rise further as the European bond market prices in better economic growth.

Bond yields historically increased following more aggressive action from central banks. Although the ECB stopped short of announcing bond purchases, it may be expanding its balance sheet once again due to the new measures announced. More aggressive action, such as outright bond purchases (known as quantitative easing, or QE), has often resulted in higher bond yields and German yields may follow a similar pattern [Figure 3]. Japanese government bond yields surged just before and after the announcement of additional QE by the bank of Japan in early April 2014.

3 Bond Yields Often Move Higher Following More Aggressive Central Bank Action



Source: LPL Financial Research, Federal Reserve, ECB, Bloomberg 06/09/14

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At a minimum, German bonds may be in a wait-and-see mode given the ECB moves. If German bond strength fades, it may remove a pillar of support from U.S. Treasuries. Spanish and Italian government bond yields may remain low, but the capacity for a further decline is likely limited having reached all-time record lows.

Favorable yield differentials may aid Treasury demand but as European bonds begin to focus on growth, U.S. bonds may turn their attention to the Fed. Recent economic data have provided more evidence of a rebound from the first quarter of 2014, when severe winter weather adversely impacted the economy. The Fed may cite the improvement in economic data as more reason to remain on course with a reduction in bond purchases and an eventual rate hike.

Offside

Over the past two weeks, Fed officials have indicated displeasure with a bond market that remains offside. Futures still indicates the bond market believes the Fed will take longer to raise interest rates and raise rates at a slower pace than indicated by Fed forecasts.

No European country has ever won the World Cup when a South American nation has hosted the event. The top two teams ranked by FIFA, soccer's world governing body, are from Europe and pose a challenge to host nation Brazil's attempt to win a sixth world cup. However, oddsmakers have both Brazil and Argentina as more likely to win the tournament. It seems the gambling community, a proxy for the market, is respecting geographic biases of the World Cup. Will the bond market respect the prospects of better economic growth in the form of higher yields? Stay tuned. ■