Bond Market Perspectives

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Is It Extreme?

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Highlights

Although the decline in US Treasury yields has been significant in 2014, it is not quite at an extreme when viewed historically.

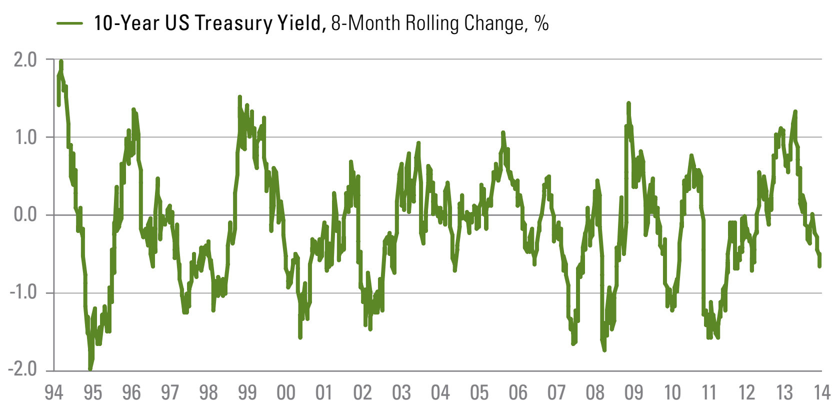
However, the decline in European government bond yields has reached an extreme.

Given the influence of European government bond yields on U.S. yields, this week's ECB meeting may determine the market's next move.

Following an extended market move, either higher or lower, investors ask is it extreme? If the answer is yes, then the market may be subject to a reversal, as surprising strength can bring in profit taking while persistent weakness can bring in buyers taking advantage of better values. Last week (August 25–29, 2014) bond yields resumed their move lower both in the United States and overseas. After stagnating in June and July, domestic bond prices resumed rising. Bond market strength was fairly broad based, as most segments of the bond market enjoyed gains. Within the bond market, the continued decline in US Treasury yields, which fell back to year-to-date lows, is perhaps most noteworthy—especially given the steady beat of improving U.S. economic data.

A look back at notable declines in bond yields shows that the current move is not necessarily extreme. Since the beginning of the year, the 10-year Treasury yield has declined by 0.7% through the end of August. The 2014 change is significant, but, compared to all other eight-month periods, not quite at an extreme that has sparked prior market reversals [Figure 1]. In fact, the current decline in Treasury yields remains shy of the two most recent extended declines, in late 2010 and in 2011. Both of these periods corresponded to European-led economic and debt concerns. European economic concerns are a major factor in today's market.

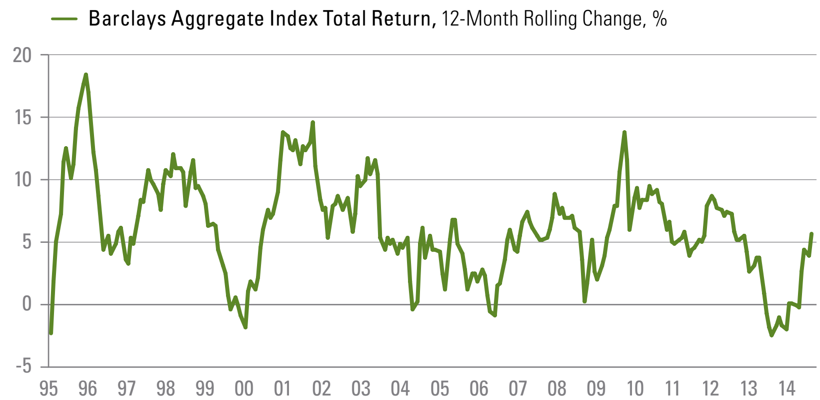
1 The Decline in the 10-Year Treasury Yield is Notable but Not Quite Extreme



Source: LPL Financial Research, Bloomberg 08/29/14

Total return data, price changes and interest income, also suggest that year-to-date strength of the high-quality bond market has not yet reached an extreme. While the Barclays Aggregate Bond Index is up about 5% during the past 12 months, the total return is shy of the 7–8% total return that marked strong one-year runs in 2010 and early 2012 [Figure 2].

2 Bond Total Returns Are Also Not Quite at Extremes



Source: LPL Financial Research, Barclays Index data 08/29/14

The Barclays Aggregate Bond Index is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

Extremes are evident during sell-offs, as Figure 2 also shows. Last year's taper tantrum sell-off was one of the most severe on record and indicated a potential bottom as the 12-month rolling total return fell to a negative 2.5%. Extremes reached in 2000, 2004, and 2006 served as bottoming signals for the bond market and performance subsequently improved.

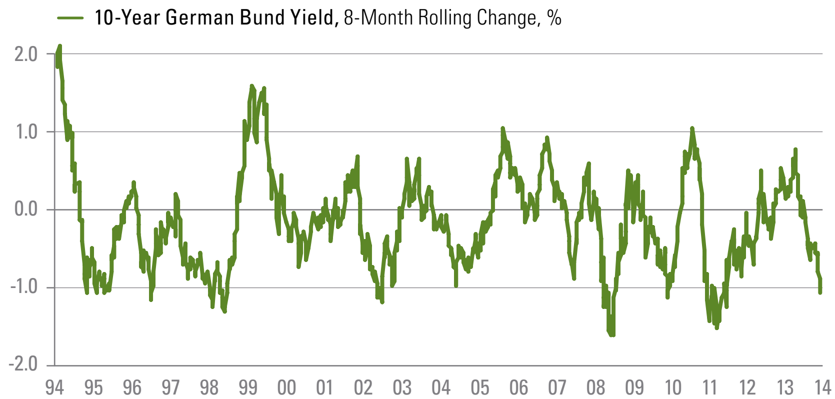
European Government Bonds Approaching Extremes

The 10-year German Bund yield has declined by more than 1.0% since the start of 2014, one of the largest drops over an eight-month period.

The 10-year German Bund yield decline, on the other hand, shows signs of an extreme move. The 10-year German Bund yield has declined by more than 1.0% since the start of 2014, one of the largest drops over an eight-month period [Figure 3]. The current move is similar to the 2010 decline and is approaching the magnitude of the 2011 decline. As history shows, such extended yield moves are rare and suggest European government bond strength may be nearing an end.

This week's European Central Bank (ECB) meeting is therefore key to the direction of European government bond prices and yields, which may in turn influence U.S. bond markets. Expectations of bond purchases from the ECB, either via the buying of asset-backed securities (ABS) or government bonds, have been a primary driver of European government bond strength, which has benefited peripheral government bond issuers such as Italy, Spain, and Portugal. Recent weak economic data in Europe has only bolstered

3 European Yield Declines Have Reached Extremes



Source: LPL Financial Research, Bloomberg 08/29/14

expectations of ECB action. Please see our *Weekly Economic Commentary: Central Bankapalooza*, dated September 2, 2014, for further discussion on potential ECB actions.

Should the ECB make no announcement regarding bond purchases, European government bond yields may remain near current record low yields. The threat of deflation, in absence of more aggressive action from the ECB, may likely keep prices supported. Conversely, a larger-than-expected dollar amount of ABS purchases may push yields higher if investors believe it will stimulate economic growth. A similar reaction occurred in the United States following the Federal Reserve's (Fed) first two announcements of bond purchases, known as QE1 and QE2.

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Absolute changes in bond yields are not the only determinate of market changes. However, an extended move higher or lower in bond yields can help determine whether a market move is extended and closer to ending or subject to a reversal. Observing absolute yield changes shows that intermediate and long-term U.S. yield declines are significant but short of reaching prior historical extremes. U.S. bonds may therefore not quite be ready to reverse. Based on this metric alone, and the fact that the 10-year Treasury yield does not encounter significant resistance, based on technical analysis, until 2.25%, strength may therefore persist a bit longer.

Conversely, European government bond yield declines have reached a historical extreme, suggesting that action from the ECB is largely anticipated and priced into markets. Yields may stay low if the ECB refrains from more aggressive action, such as bond purchases, as investors assess the extent of ongoing economic deceleration. Nonetheless, the high correlation between German yields and US Treasury yields suggests European price action may signal the next move for U.S. bonds. Waning strength suggests that a dominant driver of U.S. bond yields may be fading as well. ■

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