LPL RESEARCH

BOND MARKET PERSPECTIVES

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WHAT IS DRIVING BOND YIELDS?

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KEY TAKEAWAYS

The fall in 10- and 30-year Treasury yields over the second half of 2014 has been driven primarily by falling inflation expectations, rather than concern over the health of the U.S. economy.

The decline in European government yields, unlike U.S. Treasuries, reflects both bleak growth prospects and lower inflation expectations.

The direction of bond yields, up or down, can send signals about the economy, the pace of inflation, or the prospects of future interest rate changes by the Federal Reserve (Fed). Last week (January 5–9, 2015), the 30-year Treasury yield retouched an all-time record low of 2.52% [Figure 1], first reached in December 2008 and again in June 2012. Such a low yield could be seen as a warning sign from the bond market to investors.

However, it is important to understand the dominant driver of falling yields — the Fed, economic growth, or inflation — before deciding whether yields are sending any kind of warning. Although these three factors are certainly not all-inclusive (many factors can influence bond yields), they have historically been the primary drivers of bond yields over time. Understanding which component has had a greater influence can help clarify the message from forward-looking financial markets.

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Yields are quoted on a nominal (or absolute) level, but understanding the change in the composition of the yield number is essential. The nominal yield is comprised of an inflation expectation* (to compensate investors for erosion

1 THE 30-YEAR TREASURY YIELD RETOUCHED AN ALL-TIME RECORD LOW

Source: LPL Financial Research, Bloomberg 01/12/15

*Inflation expectations can be measured several ways, but here we measure by the "break-even inflation rate" implied by current Treasury Inflation-Protected Securities (TIPS) pricing (as seen in Figures 2 and 3).

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due to inflation) and a real, or inflation-adjusted, yield, which is essentially the risk premium (paid to investors) for uncertainty around economic growth and other future risks that may arise. Thus, subtracting the inflation expectation from the nominal yield produces the real yield.

Nominal Yield = Inflation Expectation + Real Yield

The fall in 10- and 30-year Treasury yields over the second half of 2014 has been driven primarily by falling inflation expectations, rather than concern over the health of the U.S. economy. Decomposing the recent move in longer-term Treasury yields between inflation compensation and real yield can help illustrate how declining inflation expectations have pushed yields lower [Figure 2]. As the diagram shows, the fall in inflation expectations over the second half of 2014 pulled down the nominal 10-year Treasury yield (the number we see reported), despite an increase in the real yield.

The increase in real yields was the bond market's acknowledgment of the steady pace of economic growth over the final three quarters of 2014. The bond market's message, therefore, is that longer-term Treasury yields are declining in response to lower inflation expectations, rather than a deteriorating economy. Of course the two are related, as stronger economic growth is more likely to generate inflation and vice versa; however, the decline in oil prices and lack of wage pressures have pushed inflation expectations lower—the main factor driving current bond yields.

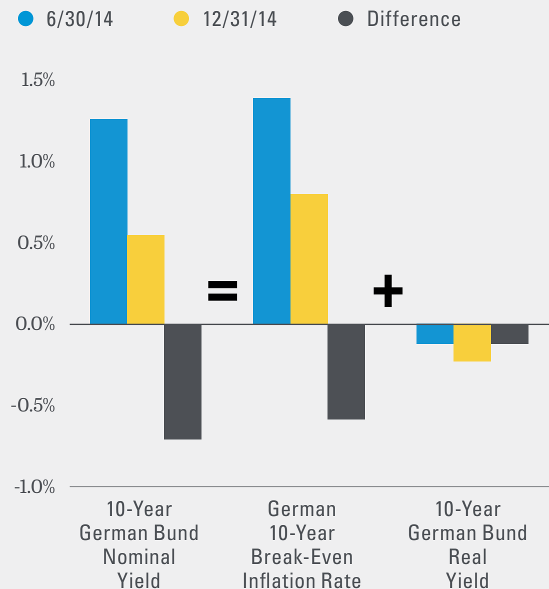
DRIVERS OF EUROPEAN YIELDS

In European government bond markets, the change in real yields reveals a different story. The decline in European government yields, unlike U.S. Treasuries, reflects both bleak growth prospects and lower inflation expectations [Figure 3]. Inflation expectations in Europe have fallen dramatically, even more so than in the United States, and have still been the primary driver of falling nominal yields. Unlike U.S. Treasuries, however, the nominal

2 LOWER INFLATION EXPECTATIONS HAVE BEEN THE DOMINANT DRIVER OF YIELDS OVER THE PAST SIX MONTHS

Source: LPL Financial Research, Bloomberg 01/12/15

3 THE DROP IN EUROPEAN YIELDS REFLECTED BOTH LOW INFLATION AND WEAKER GROWTH EXPECTATIONS



Source: LPL Financial Research, Bloomberg 01/12/15

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yield on the German Bund has fallen even more than the decline in inflation expectations, which means the real yield on the German Bund dropped as well. The reduced risk premium, or real yield, on German bonds reflects a more pessimistic economic scenario. This is different than what Treasuries demonstrated and is a bearish signal from the bond markets regarding economic prospects in Europe.

AN INCREASINGLY GLOBAL WORLD

Bond yields declined in Europe in 2014 across the maturity spectrum and remain at or near all-time record lows at the start of the new year. This has rendered U.S. Treasuries more attractive by comparison, as the yield advantage has kept foreign buyers active in the U.S. Treasury market. Compared with the 0.0% yield on German and Japanese five-year government bonds, the U.S. five-year Treasury yields a "hefty" 1.4%, with larger differentials available on longer-term issues. This foreign buying is helping to keep U.S. yields lower than they would otherwise be, and another reason why declining nominal long-term yields are not necessarily negative indicators of U.S. economic growth, as investor flows are having a significant impact.

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Treasury real yields declined over the first full week of 2015 as the increasing likelihood of government bond buying by the European Central Bank, terrorist attacks in France, and more mixed economic data on the U.S. economy's performance during December 2014 has lowered risk premiums. A further decline in oil prices pushed inflation expectations lower as well.

GOOD FOR THE ECONOMY, BAD FOR BONDS

Although the real yield of the 10-year Treasury increased over the second half of 2014, the increase was modest and showed the significance of foreign investor flows and global events. Nonetheless, real yields remain low by historical standards and provide investors limited opportunity. Stabilization in oil prices could eliminate the tailwind of lower inflation expectations. The hidden message of higher real U.S. Treasury yields bodes well for the U.S. economy, even though implications for bond investors may be negative in the longer term.

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The resilience of the U.S. economy, combined with the boost that low oil prices may provide the economy, may lead to a difficult return environment for bonds in 2015. Stabilization in oil prices could lead to stable or rising inflation expectations, which could increase nominal yields and hurt bond prices, all else being equal. We still believe bonds should be "handled with care" in 2015, as discussed in LPL Research's *Outlook 2015: In Transit*. ■

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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.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical, tax, and regulatory risk, and risk associated with varying accounting standards.

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