Bond Market Perspectives

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Irrepressible Bonds

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Highlights

Investor positioning and changed Federal Reserve expectations had a particularly beneficial impact on robust bond market performance in May.

Unbalanced investor positioning may have run its course, and investor expectations about the Fed may be as good as it gets.

The march higher in bonds took a bold step forward last week as the 10-year Treasury yield dropped below 2.5% briefly, the low end of a multi-month yield range. Bond strength came amid little to no news, making the most recent run-up in bond prices peculiar but similar to other bouts of strength over the past two months.

Last week's gains have pushed the Barclays Aggregate Bond Index up near 4% year to date through the end of May 2014. There have been multiple drivers of the bond market rally, which we highlighted in the May 6, 2014, *Bond Market Perspectives: The New Conundrum*. Most are generally still impacting the market even though June has begun on a soft note.

Two drivers have had a particularly strong influence as of late: investor positioning and changing expectations of the Federal Reserve (Fed).

Positioning

The expectation of stronger economic growth and a Fed that is slowly moving toward raising interest rates fostered expectations of rising bond yields and lower prices. Institutional investors, such as hedge funds, had placed bets on lower prices, known as short selling. However, as bond prices have increased, leading to losses on short positions, investors have had to scramble to buy back bonds, pushing prices higher in the process. Timing of such flows is difficult to anticipate but helps to explain bond strength on days without significant news or even in the face of strong economic data, which would normally pressure prices higher.

The strength in bonds can also force the hand of some investors who were underinvested in bonds overall or overinvested in short-term bonds. Investors who are underinvested in bonds or who positioned portfolios to have less interest rate sensitivity relative to the broad market see smaller gains in their portfolios as bond prices rise. When bond strength becomes extended, investors often buy longer-term bonds for fear of missing out on additional bond price gains. Such buying can create additional momentum for the bond market.

Significant short covering in the Treasury market last week may help explain a spike lower in yields in the absence of news. Net short positions in 10-year futures declined to a near neutral level of 19,000 contracts for the week ending May 27, 2014, versus a prior net short of 97,000 [Figure 1]. The reversal in short positions was one of the largest weekly moves of

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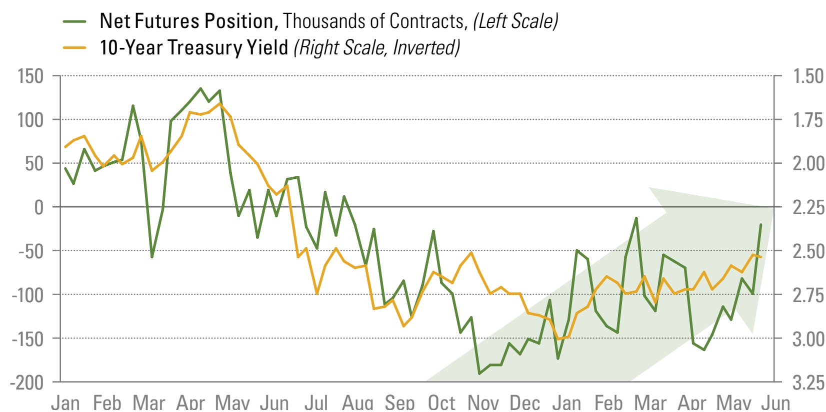
the past few years according to Commodities Futures Trading Commission (CFTC) data. While certainly not the only driver of yields year to date, offside positioning has helped drive bond prices particularly in April and May 2014. Positioning is much more balanced now, suggesting short-covering momentum may fade.

1 A Reversal of Bearish Bond Bets Has Helped Treasuries in Recent Months



Source: LPL Financial Research, Bloomberg, CFTC 05/30/14

Past performance is not indicative of future results.

Fed Expectations

Changing market expectations of how high the Fed may ultimately raise interest rates has been a theme over the second half of May. The Fed's economic projections include a forecast of the long-term "neutral" target fed funds rate. This projection reflects where Fed members estimate the target fed funds rate would rest in a neutral environment and is currently estimated at 4%. But investors have questioned whether the economy could withstand such a short-term borrowing rate and whether the target fed funds rate may rest at 2% or 3%, for example, rather than 4%.

Public comments from current and past Fed officials have supported the theory that the target fed funds rate may not rise as high as 4%. Recently, New York Fed President Bill Dudley stated that the target fed funds rate will likely rest "well below" 4.25%, especially if inflation remains subdued. Former Fed Chairman Ben Bernanke stated at a recent dinner event that he does not expect to see a 4% target fed funds rate in his lifetime.

If short-term rates do not rise as much as projected by the Fed, then it follows that current intermediate- and long-term yields need not rise as high in response, and longer-term Treasury yields may be more attractive.

However, yields should still be higher even using this analysis. Over the long term, the 10-year Treasury yield has averaged 1.2% more than the target fed funds rate. Adding 1.2% to a 2% target fed funds rate would equate to a 3.2% 10-year Treasury yield, while a 3% target fed funds rate would equate to a 4.2% 10-year Treasury yield. These are hypothetical examples but still

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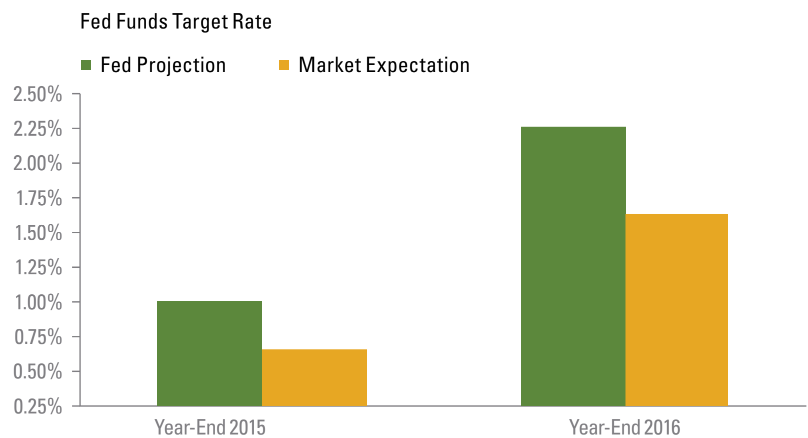
show how future bond yields may likely be higher than today's rates. Granted interest rates may not rise as high, which may reduce risk for bond investors, but they are still likely moving higher as the Fed normalizes policy.

A lower fed funds rate implies longer-term bond yields may not rise as high, but the headwind of rising interest rates is not eliminated. A very low return environment for bond investors still remains. In our view, the bond market has priced in a lot of the good news about a friendly Fed. Market rate hike expectations are very benign [Figure 2].

In our view, the bond market has priced in a lot of the good news about a friendly Fed.

2 Market Rate Hike Expectations Differ Significantly From Fed Forecasts



Source: LPL Financial Research, CBOT, Federal Reserve 06/02/14

Unbalanced investor positioning may have run its course, and investor expectations about the Fed may be as good as it gets. An announcement of steps to further boost economic growth by the European Central Bank this week coupled with improving domestic economic data may begin to turn the tide on an irrepressible bond market this year. ■

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