Bond Market Perspectives

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Fed Reacquaintance

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Highlights

Unlike weather-impacted economic data or geopolitical tensions, the Fed is likely to reiterate its gradual journey to less bond market-friendly policy.

A change in the Fed's forward guidance to more qualitative measures may pressure bond prices lower and yields higher as the bond market prices in uncertainty.

This week the bond market looks to get reacquainted with an old friend, the Federal Reserve (Fed). The relationship between the Fed and the bond market is a long one, and like a long-time friend, the Fed's influence on the bond market is strong and needs respect. Unlike the weather-impacted economic data, which has helped suppress economic activity during the first quarter, and tensions in Ukraine, which has boosted demand for high-quality assets, the Fed is less likely to be supportive of bond prices.

With Treasury yields back near the low end of a now nine-month trading range, a less market-friendly Fed augurs for higher yields [Figure 1].

1 A Reminder of a Less Market-Friendly Fed May Pressure Yields Up From the Low End of the Range

Source: LPL Financial Research, Bloomberg 03/17/14

This week's Fed meeting, which will conclude on Wednesday, March 19, 2014, will be the focal event for bond investors (for more on this week's Fed meeting please see *Weekly Economic Commentary: Making a Statement,* 03/17/14). The market will focus on two factors:

- **Bond purchases:** The Fed is widely expected to reduce bond purchases by another $10 billion this week as it continues to remove accommodation. A pause in tapering, or a greater reduction in purchases, would likely have a market impact but is unlikely. Fed officials continue to indicate the bar to suspend or slow the pace of tapering bond purchases is high, and we expect a continued $10 billion reduction as per their original guidance.

- **Forward guidance:** The Fed is also expected to change the way it communicates "forward guidance" — factors that may have influenced the timing of a first interest rate hike and the pace of rate hikes thereafter. The Fed has stated it would not raise interest rates until the unemployment rate fell below a 6.5% threshold, but this measure has become increasingly meaningless with unemployment hovering just above it.

Several Fed officials have suggested a move towards more "qualitative" guidance, which may boost uncertainty and pressure bond prices lower and yields higher. Historically, the knee-jerk reaction by bond investors, when faced with Fed policy uncertainty, is typically higher yields, as investors demand greater compensation for greater interest rate uncertainty.

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Fed Uncertainty and Bond Yields

Last spring, then Fed Chairman Ben Bernanke's first mention of the word "taper" helped fuel a violent bond market sell-off. Tapering suggested a looming shift to a less bond market-friendly policy. While last year's bond market reaction was sparked by the Fed's apparent change in tack, the timing, dollar amount, and duration of any potential taper was completely unknown at the time and likely exacerbated the move higher in bond yields in 2013.

A pending leadership change at the Fed added to the uncertainty. The rise of Larry Summers, and his perceived less market-friendly views, as potential challenger to Janet Yellen, suggested Fed policy could take two divergent paths depending on who would end up in charge of the Fed. Bond yields rose as a buffer against this lack of clarity but subsequently fell once Summers withdrew his name for Fed Chairman consideration.

Most recently in February 2014, the Bank of England (BoE) shifted from threshold-based guidance to qualitative guidance. Similar to the Fed, the BoE had an unemployment rate threshold but at 7% compared with the 6.5% of the Fed. As the unemployment rate dropped close to the threshold, the BoE shifted to more qualitative guidance — a group of economic indicators that would influence the potential timing of an interest rate hike rather than a limited number of economic metrics such as the unemployment rate.

United Kingdom government bond yields initially rose in response to the BoE's new qualitative guidance, as bond investors were not sure what to make of the shift. Yields on intermediate government bonds increased by 0.1% to 0.15% in the days after the February 2, 2014 BoE meeting before coming back down as Ukraine tensions escalated. However, short-term U.K. government bond yields jumped again in early March on stronger-than-expected economic data. The combination of strong data with vaguer qualitative guidance has been a one-two punch to keep short-term bonds under pressure. Short-term yields are more sensitive to potential changes in central bank policy rates. The 2- to 5-year U.K. gilt yields are now 0.1% to 0.3% higher compared with the February 2014 lows.

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The main difference between U.K. and U.S. monetary policy, however, is that inflation is running ahead of the central bank's objective in the

U.K. but not in the U.S. Higher U.K. inflation is one reason why the U.K. government bond market may be more sensitive to stronger economic data or signs of a rate hike. Futures show the first BoE rate hike to occur in early 2015 compared with late 2015 for the Fed's first rate hike. The inflation differential is worth noting but shows how bond markets typically react to monetary policy uncertainty with higher yields.

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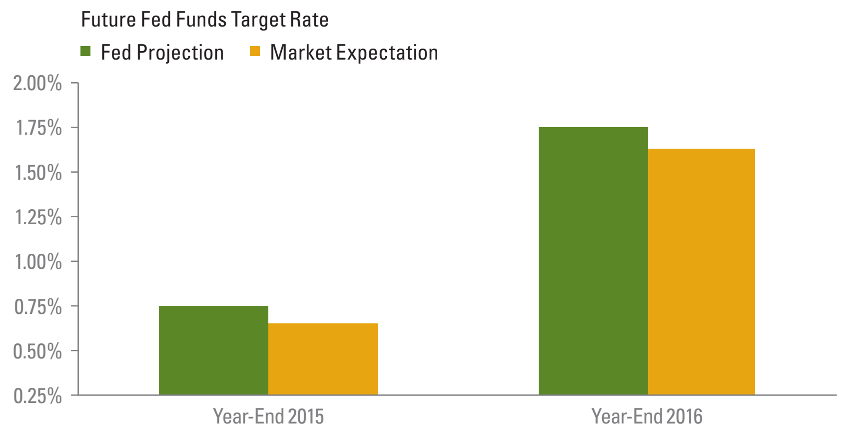
Treasuries remain priced expensively for an eventual Fed rate hike even if a long way off. At 0.36% (as of Monday, March 17, 2014), the 2-year Treasury yield is only 0.11% higher than the upper end of the Fed's 0% to 0.25% range for the benchmark target fed funds rate. The last three times the Fed initiated a rate hike campaign (1994, 1999, and 2004), the 2-year Treasury yield averaged a 1% yield advantage over the prevailing target fed funds rate. Although a first rate hike is not imminent, Treasury yields are also far away from average levels that preceded prior Fed rate hike regimes.

The bond market continues to indicate the Fed may take longer to raise interest rates than current Fed guidance indicates [Figure 2]. This week's

2 Bond Market Pricing Already Assumes a More Benign Fed



Source: LPL Financial Research, CBOT, Federal Reserve 03/17/14

Fed meeting will provide the first economic projections since December 2013, including the timing of a first rate hike and expectations for the path of the fed funds rate. In our view, economic projections are likely to be little changed, and the bond market is unlikely to receive an additional lift from the Fed if rate hike forecasts are unchanged.

Conclusion

A strong first quarter of 2014 for the bond market is winding down. Weather-impacted economic data and geopolitical risks have provided a helping hand for bond prices, but this week the bond market gets reacquainted with the Fed, which remains on a less friendly market course.

We expect the Fed to remain on track, and a change in the Fed's forward guidance to more qualitative measures may pressure bond prices lower and yields higher as the bond market prices in uncertainty.

The Fed could surprise and delay their eventual exit, in which case bond prices may rise anew. We expect the Fed to remain on track, and a change in the Fed's forward guidance to more qualitative measures may pressure bond prices lower and yields higher as the bond market prices in uncertainty. We still advocate high-quality intermediate bonds in combination with high-yield bonds and/or bank loans as a defensive posture against a gradual rise in interest rates. ■

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