Bond Market Perspectives

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The Future According to the Bond Market

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Highlights

At any given time, current bond market pricing may provide a view of future economic growth, interest rates, inflation, and when the Federal Reserve (Fed) may raise interest rates, how fast, and by how much.

The low level of longer-term bond yields, a flatter yield curve, and subdued inflation expectations all could signal a sluggish economic environment.

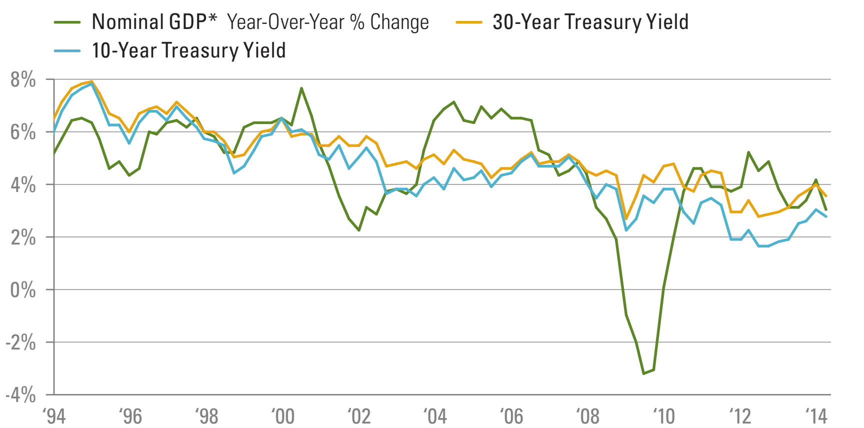
Bond market indicators do not always come to fruition and taking a contrarian view from future indications may provide opportunities.

Like all financial markets, the bond market is a forward-looking market that can reflect future expectations. But when it comes to prophesying the future, no financial market matches the scope of the bond market. At any given time, current bond market pricing may provide a view of future economic growth, interest rates, inflation, and when the Federal Reserve (Fed) may raise interest rates, how fast, and by how much.

Economic Growth

The Fed maintains strong control over short-term interest rates, but longer-term interest rates reflect expectations about economic growth. In its simplest form, a long-term Treasury yield, such as the 30-year, can be broken down into two components: growth and inflation, which combined make up the yield. The 30-year Treasury yield therefore reflects the rate paid to investors to compensate for long-term economic growth and inflation risks over that time. While Fed bond purchases have distorted this relationship in recent years, it is still valid and the relationship between 10- and 30-year Treasury yields and year-over-year economic growth is clearly visible [Figure 1].

1 Treasury Yields Have Fallen to Reflect Slower Growth



Source: LPL Financial Research, Bloomberg 04/07/14

* GDP line includes 1.5% real GDP estimate for 1Q14

Past performance is no guarantee of future results.

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Reduced Fed bond purchases have been factored in by the bond market, and the decline in Treasury yields over the first quarter of 2014 reflects lackluster economic growth. Severe weather likely played a role, but consensus forecasts are expecting a deceleration in nominal gross domestic product (GDP) growth for the first quarter (note "real" or inflation-adjusted GDP is most often cited by the popular media but we use nominal GDP for a like comparison with bond yields).

The low absolute level of yields overall also suggests that the bond market remains unconvinced of a big surge in economic growth. Another way to think about 10- and 30-year Treasury yields is as a representation of aggregate demand in the economy, particularly with regard to loan demand. Rates may be low to reflect subpar demand for borrowing.

Perhaps the ultimate arbiter of economic strength is the yield curve. An inverted yield curve—a condition when long-term Treasury yields fall below those of short-term Treasury yields—has preceded every recession. A steep yield curve, on the other hand, can reflect improving prospects for economic growth. Over the first quarter of 2014, the yield curve flattened (long-term yields fell more than short-term yields), which is a bond market signal for slower future economic growth. Although the yield curve flattened over the first quarter, it remains steep by historical comparison [Figure 2], suggesting that while the bond market priced in slower growth over the first quarter, it still may reflect an outlook for growth.

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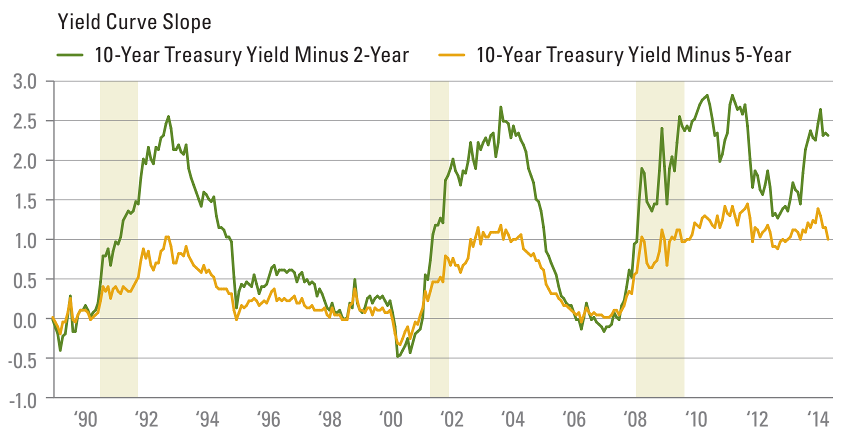
2 The Yield Curve Still Signals Growth Despite a Flatter Curve in the First Quarter



Source: LPL Financial Research, Bloomberg 04/07/14

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The Fed's zero interest rate policy has influenced the shape of the yield curve and has raised questions about the usefulness of the yield curve as an economic indicator. Figure 2 also includes measuring yield curve slope using 5-year Treasury yields, which are far less influenced by Fed policy than 2-year Treasury note yields. This measure also shows a still-steep yield curve.

Inflation

There are many ways to decipher the rate of inflation the bond market expects in the future, but the easiest measure is with Treasury Inflation-Protected Securities (TIPS). TIPS pay a base yield with the rest of investor return coming from annualized inflation, which is unknown at time of purchase. Subtracting the yield of the 10-year TIPS from the conventional 10-year Treasury yield reveals the market's inflation expectation over a 10-year horizon. Inflation expectations have declined recently and reside near recent lows [Figure 3].

3 The Bond Market Does Not See an Inflation Threat

Source: LPL Financial Research, Bloomberg 04/07/14

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Inflation expectations have been broadly stable since mid-2013. Inflation expectations actually declined during last year's bond market sell-off, indicating that rising yields in the bond market were pricing in better economic growth rather than stronger inflation.

As inflation expectations decline so do bond yields, as this enemy of bond investors is viewed as less of a threat. Inflation expectations have been broadly stable since mid-2013. Inflation expectations actually declined during last year's bond market sell-off, indicating that rising yields in the bond market were pricing in better economic growth rather than stronger inflation. Should rising inflation expectations accompany better growth expectations, bond yields may rise more sharply than anticipated.

One caveat about TIPS is that they are indexed to overall Consumer Price Index (CPI) inflation, which can be influenced by energy prices. A surge in oil prices can therefore distort inflation expectation readings over short time periods, but this is more of an issue with short-term TIPS, which have less time to shake-off the impact of oil-price related CPI swings.

Future Yields

In general, forward interest rates indicate what the market currently expects bond yields will be at a future point in time. For example, the 5-year Treasury yield closed Monday, April 7, 2014, at a 1.68% yield. However, according to the implied forward curve the 5-year Treasury yield will be

2.4% one year from now and 3.1% two years from now. These forward rates are based on current yields and therefore constantly change along with the market but give investors a guide of what the broad market expects.

The Fed

One of the most widely watched indicators of the future is the fed fund futures contract. Fed fund futures convey the expected timing of the Fed's first interest rate change and also how fast, or slow, the Fed may be with raising or lowering interest rates.

Currently, the bond market believes the Fed will take longer to initiate interest rate hikes and then take a slower approach than indicated by current Fed guidance [Figure 4]. This reaction is partly due to the Fed's recent history of often overestimating the pace of economic growth and inflation remaining stubbornly below its 2% objective.

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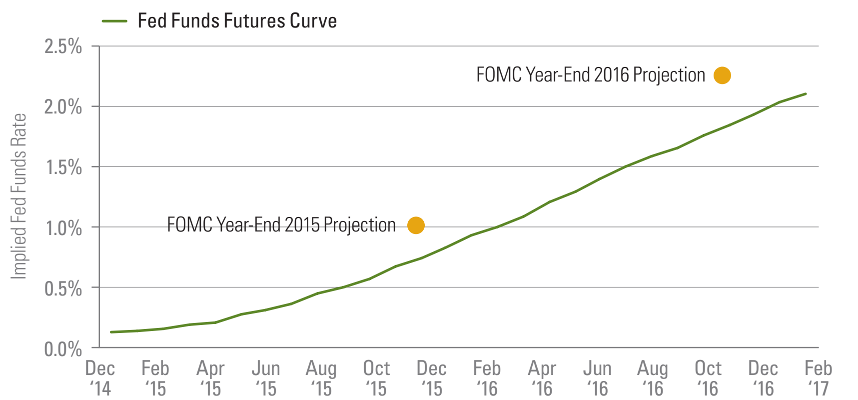
4 The Bond Market Expects the Fed to Take Longer to Raise Rates



Source: LPL Financial Research, CBOT, Federal Reserve 04/07/14

Chart shows median rate from the FOMC strategic economic projections.

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Do They Work?

Despite all the ways to gaze upon the future in the bond market, many of the prognostications fail to come to fruition. For example:

- The 3-month forward yield of the 10-year Treasury at the end of April 2013 was 1.82%, only 0.07% above the rate at that time. When late July 2013 arrived the actual rate was 2.60%.
- In July 2000, fed fund futures indicated a slight risk of an additional rate hike over the coming six months, but the Fed actually lowered interest rates in January 2001. Fed fund futures eventually correctly anticipated rate cuts but were slow to anticipate the extent of rate cuts.

So how do investors interpret the bond market's visions of the future? The yield curve may be a useful indicator of future economic expectations. The rest, however, can be used by investors to take contrarian views. Taking an opposite view from consensus thinking may lead to profitable investments. For example, at the peak of the bond market sell-off in early September 2013, fed funds futures indicated the Fed may raise interest rates as soon as fall 2014. Such an aggressive signal would have been a sign the bond sell-off had gone too far and there was perhaps an opportunity to take advantage of higher bond yields. This projection proved false and helped establish a bottom in the bond market.

We believe the economy will shake off the winter blues and surpass low expectations over the course of the second quarter leading to potentially higher yields.

Currently, the low level of longer-term bond yields, a flatter yield curve, and subdued inflation expectations all may signal a sluggish economic environment. Bonds also expect the Fed to take longer to raise rates, which we believe is a fair expectation, but it also shows that this slow pace is already priced into the bond market. Additional catalysts, either stronger or weaker, are needed to shake bond yields from the long-standing range. We believe the economy will shake off the winter blues and surpass low expectations over the course of the second quarter leading to potentially higher yields. ■

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