Bond Market Perspectives

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Purchases Persist

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Highlights

This week's Federal Reserve (Fed) meeting will be noteworthy, as the Fed is widely expected to announce additional outright Treasury bond purchases without offsetting sells.

Fed purchases of Treasuries and mortgage-backed securities (MBS) will likely total $110–$120 billion per month and may lead to a shrinking amount of outstanding bonds.

For bond investors, additional Fed purchases will maintain the status quo and continue to benefit higher yielding segments of the bond market.

This week's meeting of the Federal Reserve (Fed) policymakers has seemingly received little fanfare as negotiations over the "fiscal cliff" continue in Washington and dominate the headlines. Yet the Fed meeting will be noteworthy, as the Fed is widely expected to announce additional outright bond purchases. Operation Twist, the Fed's maturity extension program consisting of long-term Treasury purchases offset by short-term Treasury note sales, will conclude at the end of this month. The Fed will have run out of short-term securities to sell; therefore, we believe the Fed will announce outright purchases of intermediate to long-term Treasuries starting in January 2013, in order to maintain the current pace of $45 billion per month. The Fed's goal is to exert downward pressure on intermediate and long-term interest rates and motivate investors into riskier investments.

Additional Treasury purchases would entail a further escalation of the Fed's involvement in the bond market and follow the Fed's September 2012 decision to buy $40 billion in additional mortgage-backed securities (MBS). Assuming the Fed follows through with our expected total of Treasury purchases, the Fed will be buying $85 billion worth of bonds per month, without offsetting sales, to provide still more stimulus to financial markets and the economy. Since the Fed is actively reinvesting proceeds of existing MBS holdings, which will average $34 billion per month over the final three months of 2012, the monthly purchase amount is higher at approximately $110 to $120 billion per month—an impressive dose of stimulus.

The run rate of Fed purchases totaling $110–$120 billion per month would more than offset the pace of bond market growth reflected in the $846 billion in net issuance witnessed over the first nine months of 2012 and would result in a contraction in the size of the bond market.

The bond market may be on pace to shrink should the Fed continue its current pace of Treasury purchases without offsetting sells. A look at bond

1 The Overall Bond Market Is Expanding Only Slowly Even With Steady Growth in Treasury Issuance

Outstanding U.S. Bond Market ($ Billions)

	4Q2011	3Q2012	$ Change	% Change
Treasury*	10,428	11,256	827	8%
Mortgage-Related	8,357	8,205	-152	-2%
Corporate	8,197	8,584	387	5%
Federal Agencies	2,327	2,358	32	1%
Municipal Bonds	3,708	3,719	11	0%
Money Market Instruments	2,572	2,442	-130	-5%
Asset-Backed	1,825	1,696	-129	-7%
Totals	**37,414**	**38,260**	**846**	**2%**

Source: Federal Reserve, SIFMA, LPL Financial 12/10/12

*Interest-Bearing Treasuries

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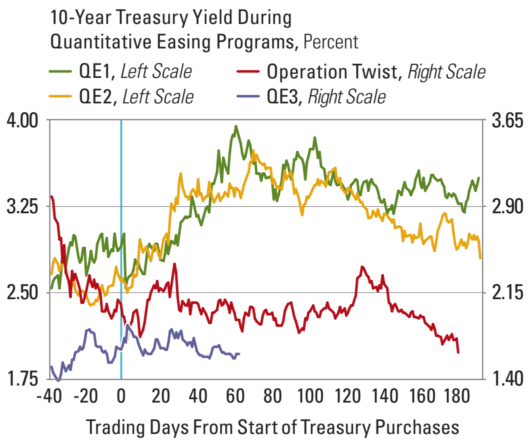
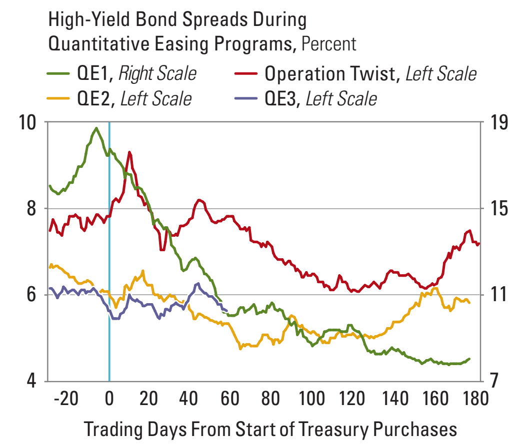
Even with the favorable-supply dynamic, additional Fed purchases are likely to maintain the status quo rather than spark a renewed rally in corporate bonds or a sell-off in Treasuries.

2 Both Treasuries and…



Source: Bloomberg, LPL Financial 12/10/12

3 …High-Yield Bonds Have Shown Diminishing Impact From Each Fed Purchase Announcement



Source: Bloomberg, LPL Financial 12/10/12

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

Operation Twist is the name given to a Federal Reserve monetary policy operation that involves the purchase and sale of bonds. "Operation Twist" describes a monetary process where the Fed buys and sells short-term and long-term bonds depending on their objective.

market growth helps illustrate the impact of Fed bond purchases. The bond market is expanding only slowly overall even with steady growth in Treasury issuance [Figure 1], as several sectors continue to shrink as the de-leveraging following the financial crisis of 2008 continues to run its course. The run rate of Fed purchases totaling $110–$120 billion per month would more than offset the pace of bond market growth reflected in the $846 billion in net issuance witnessed over the first nine months of 2012 and would result in a contraction in the size of the bond market.

Keep in mind that the bond market needs to grow modestly just to satisfy reinvestment demand. Using the average 3.6% interest rate of the Barclays Aggregate Bond Index as a proxy for the average interest paid on outstanding bonds (excluding money market instruments), the entire bond market produces $1.08 trillion in interest income. Not all interest income is reinvested, but the example shows how a favorable supply-demand balance was already in effect. Fed bond purchases mean that a slightly overall contraction will help to prop up bond prices given ongoing reinvestment demand.

Furthermore, the Fed is also widely expected to maintain its commitment to keep rates low until mid-2015, another factor supporting the bond market. By refraining to raise interest rates for such a long period of time, the Fed has greatly lessened the threat of interest rate risk from the bond market, and this aspect of policy will also help support bond prices.

Even with the favorable-supply dynamic, additional Fed purchases are likely to maintain the status quo rather than spark a renewed rally in corporate bonds or a sell-off in Treasuries. As we wrote back in September (September 4, 2012, *Bond Market Perspectives: Diminishing Returns*), additional bond purchases are having less impact with each successive operation [Figure 2]. Treasury yields rose sharply following Quantitative Easing 1 (QE1) and QE2, but the increase was short-lived following the announcement of Operation Twist, due in large part to better sentiment on European debt issues. Treasury yields increased in anticipation of the September 13, 2012 announcement of QE3 but have been little changed since.

Similarly, high-yield bond valuations improved, as measured by a narrowing yield advantage, or spread, to Treasuries in the weeks and months following each Fed bond purchase announcement [Figure 3]. However, following an initial improvement ahead of the Fed's QE3 announcement this past September, high-yield bond spreads have also been little changed. The bulk of high-yield bond outperformance since then has come from the higher yield. Nonetheless, this supports our 2013 outlook that interest income, not price appreciation, will be the driver of bond returns next year.

Conclusion – Higher Yielding Segments To Remain Well Supported

For bond investors, additional bond purchases will maintain the status quo and continue to benefit higher yielding segments of the bond market. The Fed's market-friendly stance will likely foster high valuations and low yields. Fed bond purchases have motivated investors into higher yielding segments of the bond market, such as investment-grade corporate bonds, high-yield bonds, preferred securities, and emerging market debt. This trend is likely to continue following our expected outcome of this week's Fed meeting. ■

IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

Corporate bonds are considered higher risk than government bonds, but normally offer a higher yield and are subject to market, interest rate and credit risk, as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Government bonds and Treasury Bills are guaranteed by the U.S. government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. However, the value of fund shares is not guaranteed and will fluctuate.

Investment-grade corporate bonds: The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds. The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. The range of this spread is an indicator of the market's belief in the stability of the economy.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free, but other state and local taxes may apply.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Preferred Stock investing involves risk which may include loss of principal.

A Mortgage-Backed Security (MBS) is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. Payments are typically made monthly over the lifetime of the underlying loans.

Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

High-yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

INDEX DESCRIPTIONS

Barclays Aggregate Bond Index: is comprised of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least $100 million.

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