Bond Market Perspectives

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The Great No Taper Caper

Anthony Valeri, CFA
Market Strategist
LPL Financial

Highlights

The Fed's decision to do nothing puts a floor under bond prices and indicates the bond market sell-off may be over.

A sustained, longer-term rally seems unlikely at this point since the Fed still seems poised to remove bond accommodation and a range-bound environment is likely to result until further clues about the Fed's next move become apparent.

Economic data will likely hold the solution to the Taper Caper.

The Federal Reserve (Fed) surprised investors when it announced no reduction, or tapering, of bond purchases at the conclusion of last week's Fed meeting. Never in the history of monetary policy have so many been misled by so few. The case to taper was debatable back in late spring and early summer when Fed Chairman Ben Bernanke and his compatriots first began to mention tapering. Inflation was running at a lower rate than when the Fed initiated purchases one year ago and economic growth, while improving, remained sluggish. But steady mention of the word "tapering" in public appearances by Bernanke and others indicated the Fed potentially viewed purchases as perhaps losing effectiveness, and the Fed was likely to plow ahead with a reduction in bond purchases just the same due to modest labor market improvements over the summer. For more on the economic rationale behind the Fed's possible thinking, please see this week's *Weekly Economic Commentary.*

The Fed's decision to do nothing puts a floor under bond prices and indicates the latest bond market sell-off may be over. Bond market participants rightly questioned the timing and magnitude of more restrictive policy and interest rate hikes from the Fed—one the main drivers of the sharp bond pullback from early May through early September. The Fed's no taper decision sparked a strong bond market rally with intermediate Treasury yields finishing the prior week lower by 0.18% to 0.20%. After peaking at a 3.0% yield in early September, the benchmark 10-year Treasury yield closed Friday, September 20, 2013 substantially lower at 2.73%.

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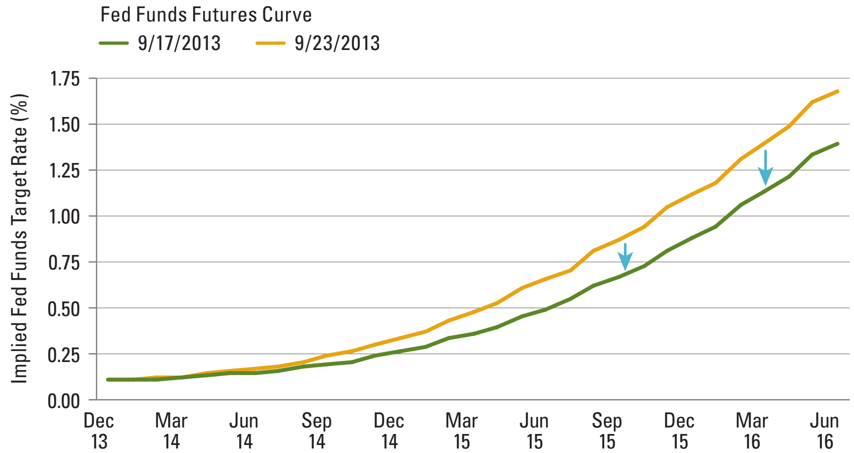
Not only did the Fed not taper, but the Fed's economic projections (which included its first forecasts through 2016) and Bernanke's press conference indicated a decidedly market-friendly tone. The Fed forecast a sluggish pace of economic growth and inflation expectations at or below its 2.0% target for the next three years. Since inflation is a primary trigger for Fed rate hikes, such a benign inflation projection indicates the Fed may wait even longer before raising interest rates and alleviated rising rate fears. That view was corroborated by a few Fed officials who pushed back their expectations for the timing of a first rate hike. Market Fed rate hike expectations finished the week sharply lower [Figure 1].

One explanation for the Great No Taper Caper is that the Fed is simply concerned about rising interest rates and the impact on the housing market and broader economy. If so, the Fed may maintain some form of accommodation longer than anticipated to help keep rates low, which would

1 Fed Rate Hike Expectations Dropped Quickly Following the Fed Meeting



Source: CBOT, LPL Financial 09/23/13

be positive for bond investors. The release of the Fed meeting minutes on October 9, 2013 may provide additional clues on this explanation.

Winners

Bonds globally received a boost from the Fed's decision, but more depressed areas of the bond market benefited most:

- **Municipal bonds.** Taxable bond market improvement is a key first step for broader municipal bond improvement. Municipal bonds had begun to improve before the Fed's meeting, but taxable bond market stability may spark longer-lasting improvement in municipal bonds as investors take greater note of attractive valuations. Even if Treasury price gains are limited, we believe municipal bonds have more to gain from the mere stability of prices, as it may spark investors to seek those sectors with the most attractive valuations and municipals fit the bill.
- **Emerging market debt (EMD).** Improving economic data helped stabilize EMD early in September, but the Fed's decision not to taper and dovish meeting results added fuel to the nascent recovery. Like municipal bonds, the reduction in rising rate fears caused investors to refocus on attractive EMD valuations. The Fed's continued bond purchases also boost bond market liquidity, which is a positive for the sector since it can be among the less liquid bond market segments.
- **Treasury Inflation-Protected Securities (TIPS).** TIPS are among the sectors most sensitive to expectations around Fed bond purchases since they enable investors to "lock-in" an inflation-protected, or real, yield. TIPS are also longer term in nature, which makes them more sensitive

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. Government.

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

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.

to the Fed's concentration on long-term bond purchases. TIPS were among the most impacted sectors during the bond sell-off, with the 10-year TIPS yield rising by 1.6%, trough-to-peak compared to the 1.3% rise in the conventional 10-year Treasury yield. A postponement of Fed withdrawal gives the sector a short-term lift as it may continue to benefit from Fed purchases.

Of the three sectors above, we find valuations more compelling on municipal bonds and EMD, while TIPS, like conventional Treasuries, remain expensive historically. We believe both sectors present a greater opportunity for investors over the intermediate to longer term based upon last week's Fed decision to postpone tapering.

Next Steps for Bonds?

On a broader level, while we believe the bond market sell-off may be over, a sustained, longer-term rally seems unlikely at this point. The Fed has made it clear that the next policy move will be a gradual reduction of accommodation and eventually, an interest rate increase, both of which are longer-term negatives for the bond market. Historically, the bond market has anticipated Fed policy changes [Figure 2] with yields typically ratcheting higher three to five months before a first rate hike based upon the last three cycles of interest rate increases. Figure 2 also illustrates that a repeat of the spring-summer sell-off is unlikely absent the onset of rate increases, which are not expected until 2015. Nonetheless, due to the uncertainty around the timing of tapering and still expensive Treasury valuations (relative to longer-term history), we see price gains as limited.

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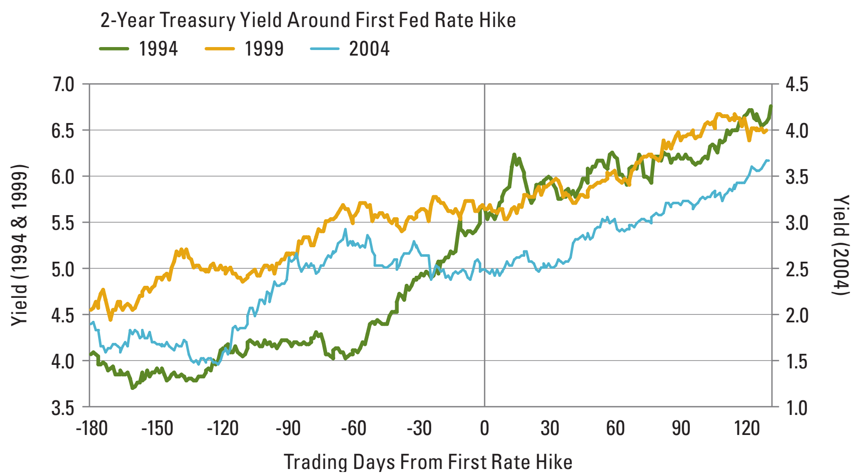
2 Historically, Bond Yields Move in Anticipation of the Fed



Source: Bloomberg, LPL Financial 09/23/13

Therefore, we see the 10-year Treasury yield range bound between 2.5% and 3.0%. The 3.0% level marks the recent peak in yields while 2.5% provided strong resistance against an initial bond rally this past July. The two yield levels represent technical levels that may bracket yields until further information becomes available.

The solution to the Great No Taper Caper may ultimately reside in the economic data. The Fed indicated that recent economic data did not warrant a tapering of bond purchases in September, so the strength of the economy, or lack thereof, will likely influence bond prices higher or lower from here. The Fed also expressed concerns with fiscal issues in Washington, and a potential debt limit fight in October, which likely means the Fed will wait until December before deciding on tapering. This gives bond investors time to assess the situation, which further supports our range-bound yield view, and will also allow interest income to continue the healing process in the bond market.

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