LPL RESEARCH
BOND MARKET PERSPECTIVES

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TAPER TANTRUM REDUX

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KEY TAKEAWAYS

Unlike the taper tantrum, which was driven by fears over the end of Fed stimulus, the current pullback is being driven by a position imbalance in our view.

Lower-rated bond sectors have fared best during the pullback.

A lower allocation to bonds overall may still be warranted, given the lack of opportunity and reduced protection offered by still historically low yields and high valuations.

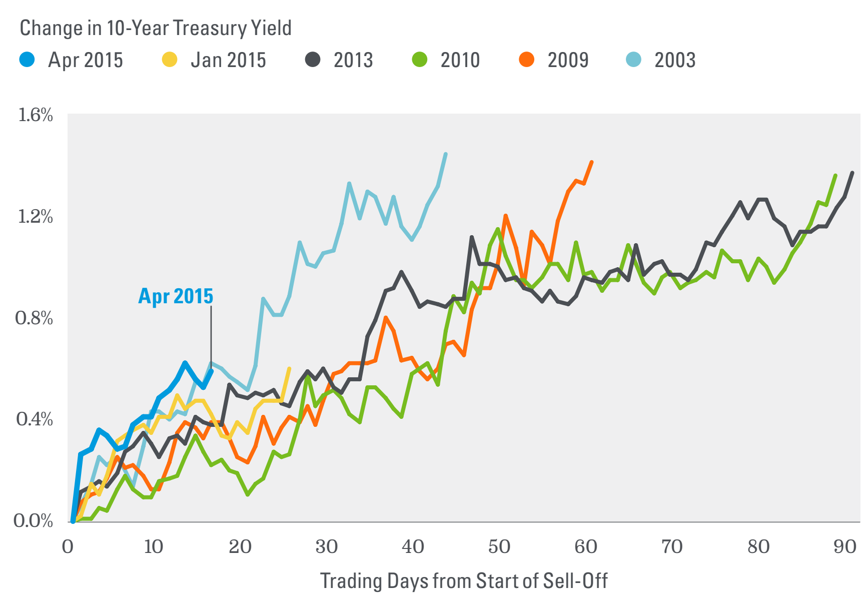
Early May represents the second anniversary of the 2013 taper tantrum bond sell-off and recent bond price movements have raised the issue of whether this is a biennial event. After a brief reprieve at the end of last week (May 4–8, 2015), the global bond sell-off resumed Monday, May 11, 2015, with 10- and 30-year Treasury yields rising to year-to-date highs of 2.28% and 3.04%, respectively. Treasury yields have now broken out of their recent ranges and have done so quickly.

The bond market pullback has been fast and furious and, so far, ranks among the sharpest corrections over such a short period of time. Since European bond weakness sparked selling on April 20, 2015, longer-term bonds have borne the brunt of selling with 10- and 30-year yields rising by 0.41% and 0.52%, respectively, while shorter-term bonds have been more insulated from price declines.

POSITION IMBALANCE

Looking back at the major bond pullbacks of the past 15 years shows that the current correction is among the swiftest. The ongoing pullback is on pace, and of similar magnitude, to the 2003 mortgage-backed securities (MBS) related sell-off [Figure 1]. That makes the current sell-off more severe than the taper tantrum in terms of speed but has a way to go to match the

1 THE PACE OF THE CURRENT RISE IN RATES IS AMONG THE FASTEST OF THE PAST 15 YEARS

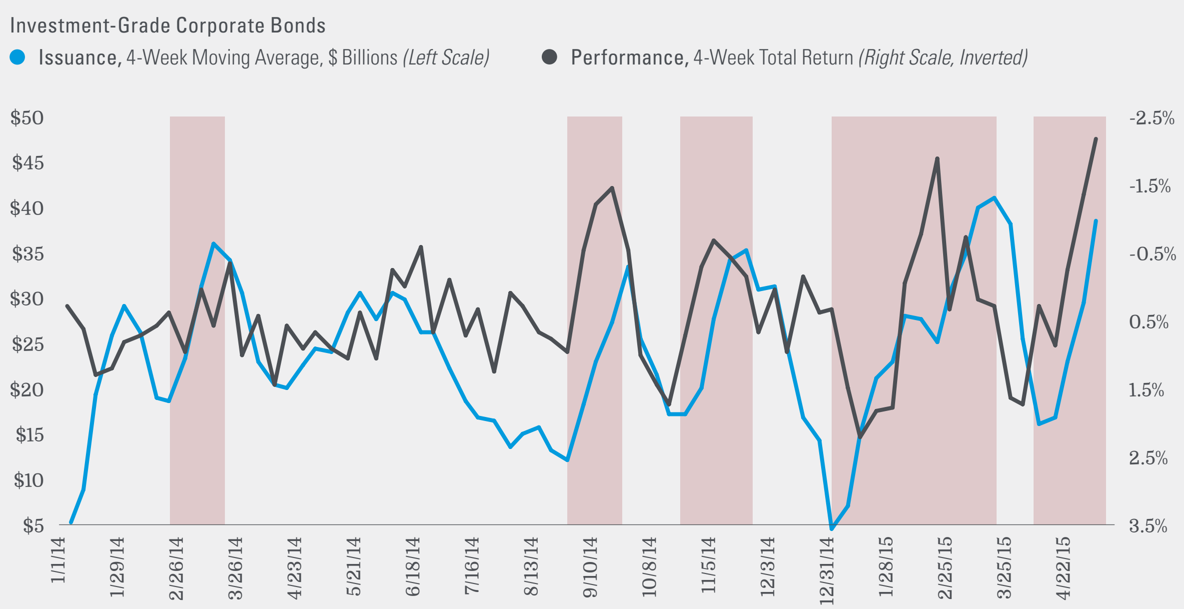


Source: LPL Research, Bloomberg 05/11/15 magnitude. A lopsided position imbalance sparked the 2003 pullback as MBS portfolio managers sold Treasuries to offset price declines in their MBS portfolios. When interest rates rise, MBS prepayments typically decline, as homeowners are less likely to refinance their underlying mortgages. The average life of MBS "extends" or essentially becomes a longer-maturity bond, and MBS portfolios hedge, or protect against this risk by selling Treasuries. Since the MBS sector comprised nearly 40% of the broad Barclays Aggregate Bond Index, a further increase in interest rates required additional hedging, and subsequent selling of Treasuries. The selling fed on itself as further losses sparked additional selling to protect against MBS declines.

Similar to 2003, position imbalances may be exacerbating price declines now. A surge in corporate bond issuance has likely contributed to bond weakness as bond dealers sell Treasuries to protect against losses on new issue corporate bond balances. Historically, periods of heavy new corporate bond issuance can weigh on investment-grade corporate bonds over short periods of time [Figure 2]. When the four-week moving average of investment-grade corporate bond issuance exceeds $30 billion, it has often sparked headwinds for performance. On a single-week basis, the week of May 4, 2015, witnessed over $50 billion in new investment corporate bonds, only the fifth week over the past year where weekly issuance exceeded $50 billion.

Additionally, as we discussed last week's *Bond Market Perspectives* publication ("Made in Europe," May 5, 2015) a heavy concentration of long-term Treasuries has restrained bond dealers from actively participating in financial markets. Position imbalances can wreak more havoc in such an environment. In overnight trading on May 7, 2015, both German Bund yields and Treasury yields spiked higher by 0.12% to 0.18%, before finishing the day unchanged to modestly positive. The

2 EXTENDED PERIODS OF HEAVY NEW ISSUANCE HAVE CONTRIBUTED TO BOND WEAKNESS IN THE PAST



Source: LPL Research, Barclays Index data, Bloomberg 05/11/15

Pink shaded areas represent periods of heavy investment-grade corporate new issuance.

quick, rapid movement was similar to the Treasury "flash crash" incident of October 2014, which was investigated by the U.S. Treasury and witnessed even greater intraday volatility. The lack of liquidity in bond trading may be playing a role once again.

NO ECONOMIC OR FED CATALYST

No economic catalyst has been directly responsible for bond price declines. U.S. economic data have been mixed at best in recent weeks, culminating with last week's good but not great monthly jobs report for April 2015, and consensus forecasts for second quarter 2015 economic growth have edged lower. Rising long-term yields may signal better growth, but growth-related bond sell-offs are rarely quick and sharp.

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Fed rate hike expectations reached their lowest levels of 2015 last Friday, May 8, 2015, as measured by fed fund futures, with a first rate hike not fully priced in until January 2016. This is the most benign signal to date. Recent weakness, therefore, cannot be attributed to fears over pending interest rate increases and, along with the absence of an economic catalyst, point to a position imbalance driving weakness.

LOWER-RATED BOND SECTORS HAVE PERFORMED BEST

Lower-rated bond sectors have performed best during this challenging period [Figure 3]. Historically, high-yield bonds and bank loans have performed best during periods of rising interest rates and have done so again recently. Emerging markets debt was resilient due to a reduction in Fed rate hike fears, a weaker U.S. dollar, and moderately attractive valuations. But following recent improvement, EMD will likely face greater headwinds. U.S. dollar weakness was a primary driver of unhedged foreign bond performance. Lower yields provide less protection against rising interest rates and the impact is reflected in hedged foreign bond exposure, which was among the weakest sectors globally. We continue to

3 LOWER-RATED BOND SECTORS HAVE WEATHERED THE PULLBACK BETTER SO FAR

April 17 – May 11, 2015 Total Returns

Sector	Total Return
Bank Loans	0.4%
High-Yield Bonds	0.2%
Foreign Bonds (Unhedged)	0.2%
Emerging Markets Bonds	0.0%
Mortgage-Backed Securities	-0.8%
Municipal Bonds	-1.0%
Municipal High-Yield Bonds	-1.2%
Barclays Aggregate Bond Index	-1.8%
Treasury Bonds	-2.0%
Foreign Bonds (Hedged)	-2.0%
Investment-Grade Corporate Bonds	-3.0%

Source: LPL Research, Barclays Index data 05/11/15

The indexes mentioned are unmanaged and you cannot invest into directly. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment. Past performance is no guarantee of future results.

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

Asset Class Indexes: Foreign Bonds (hedged) – Citigroup Non-U.S. World Government Bond Index Hedged for Currency; Treasury – Barclays U.S. Treasury Index; Mortgage-Backed Securities – Barclays U.S. MBS Index; Investment-Grade Corporate – Barclays U.S. Corporate Bond Index; Municipal – Barclays Municipal Bond Index; Municipal High-Yield – Barclays Municipal High-Yield Index; Bank Loans – Barclays U.S. High-Yield Loan Index; High-Yield – Barclays U.S. Corporate High-Yield Index; Emerging Markets Debt – JP Morgan Emerging Markets Global Index; Foreign Bonds (unhedged) – Citigroup Non-U.S. World Government Bond Index (unhedged) recommend that investors avoid developed foreign bonds, and we find high-yield bonds or bank loans in conjunction with high-quality intermediate bonds the best way to manage the current environment.

Caution is prudent as high-yield bond performance, while still positive, is low and reflects the headwinds of rising interest rates. The decline in high-yield bond yields provides less protection as well. A lower allocation to bonds overall may still be warranted given the lack of opportunity and reduced protection offered by still historically low yields and high valuations. The end of any significant bond market sell-off, or rally for that matter, is nearly impossible to time, and pullbacks driven by poor liquidity and position imbalances are especially challenging. No standout opportunity has emerged as of yet, in our view, to spark a rebound; but European futures show a small probability of a European Central Bank rate hike, which we find misguided and perhaps the first sign of an extreme that may signal an end to the pullback. ■

INDEX DESCRIPTIONS

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

Barclays U.S. High-Yield Loan Index tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the U.S. High-Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.

The Barclays U.S. Corporate High-Yield Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging market debt.

The Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC)

The Barclays U.S. Municipal Index covers the USD-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Barclays Municipal High Yield Bond Index is comprised of bonds with maturities greater than one-year, having a par value of at least $3 million issued as part of a transaction size greater than $20 million, and rated no higher than 'BB+' or equivalent by any of the three principal rating agencies.

The Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Citi World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indexes are available in any combination of currency, maturity, or rating.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

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