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SOFT START TO Q2

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KEY TAKEAWAYS

Bonds started the second quarter on a weak note as investors anticipate economic improvement during the second quarter.

However, bond market pricing indicates the Fed may never get back to "normal" and that rates will remain lower for longer.

We expect yields to start to move higher in the second quarter, but until more clarity develops, bonds yields may drift at the lower end of their recent range.

The first full week of April 2015 (April 3–10, 2015) witnessed bond prices weaken and yields reverse higher to rise by a notable 0.08% to 0.14%. The broad Barclays Aggregate Bond Index declined by 0.4%, but we do not think this is the start of a sustained trend. As discussed in last week's *Bond Market Perspectives*, "Transitioning to a Range Trade" on April 7, 2015, we expect a range-bound, "wait and see" environment to develop over the coming weeks as bond investors assess the durability of recent trends such as the stronger U.S. dollar, weak first quarter economic growth, and oil price stability, to name a few. Yields finished the month of March lower, but the lower level of bond yields warranted a rethink in early April.

SIGNS OF IMPROVEMENT

Incipient signs that the economy may be bouncing back from an uninspiring first quarter of 2015 were the primary driver of higher yields. Last week's batch of economic reports were modestly positive and helped investors forget about a disappointing March jobs report the prior week [Figure 1]. The Citigroup U.S. Economic Surprise Index began to rebound in late March continuing

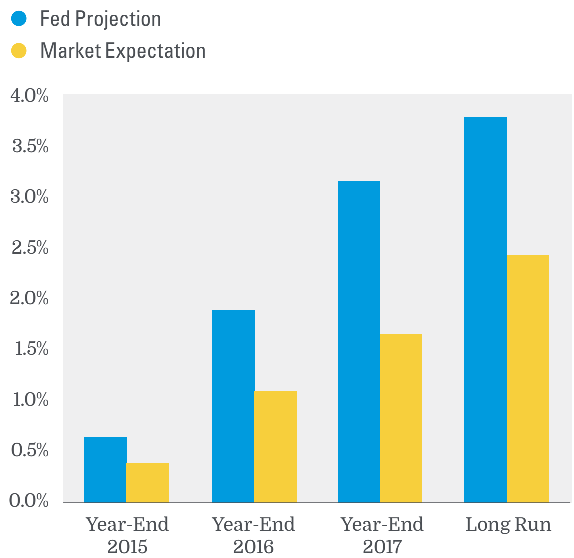
1 A REBOUND IN RECENT ECONOMIC DATA POINTS TO IMPROVEMENT IN Q2 2015

Source: LPL Research, Citigroup 04/13/15
A rising line means a majority of economic data surpassed consensus forecasts and a falling line indicates a majority have fallen short of expectations.

into April, following a period where economic reports frequently disappointed expectations, as denoted by the declining line. Fading weather-related impacts in the eastern portion of the United States and West Coast port disruptions are prompting investors to look forward to second quarter 2015 improvement.

Investors are likely taking first quarter economic growth with a grain of salt, noting a recurring trend of weaker economic growth during the first quarter of recent years. Over the last five years (2010–2014), first quarter economic growth as measured by gross domestic product (GDP), on average, has increased a meager 0.6%. Even removing 2014's surprising 2.1% decline, first quarter GDP has averaged 1.3% over the five-year time period. In that light, the Bloomberg consensus estimate of 1.4% growth for the first quarter of 2015 seems to be following a similar pattern, where seasonal factors may be creating distortions that are reversed in subsequent quarters. Q1 2015 GDP will be released on April 28, 2015.

2 MARKET RATE HIKE EXPECTATIONS ARE NOTABLY BELOW REDUCED FED FORECASTS



Source: LPL Research, CBOT, Bloomberg 04/13/15
Fed rate forecasts are from March 18, 2015.

> With an implied overnight lending rate of 2.5% five years from now (according to futures), the bond market has priced in roughly two rate hikes per year over the next five years.

BOND-FRIENDLY FED PRICED IN AGAIN

The rise in yields last week likely also reflects that much of the bad news may be priced in and there may be limited value in yields near the low end of the year-to-date range. Federal Reserve (Fed) rate hike expectations declined over the latter half of March. With an implied overnight lending rate of 2.5% five years from now (according to futures), the bond market has priced in roughly two rate hikes per year over the next five years [Figure 2]. In other words, bond market pricing indicates the Fed may never get back to "normal" and that rates will remain extraordinarily low for a long time. This pessimistic view indicates a much slower pace of rate hikes than the Fed's recently reduced rate forecasts. Weaker economic data may be needed to justify an even slower trajectory of Fed rate hikes. That has not materialized as of yet, and signs of a second quarter improvement helped pressure bond prices lower and yields higher.

THE NEXT CHALLENGE

Monthly retail sales data and the latest inflation readings for March highlight the next key readings for bond investors this week (April 13–17, 2015).

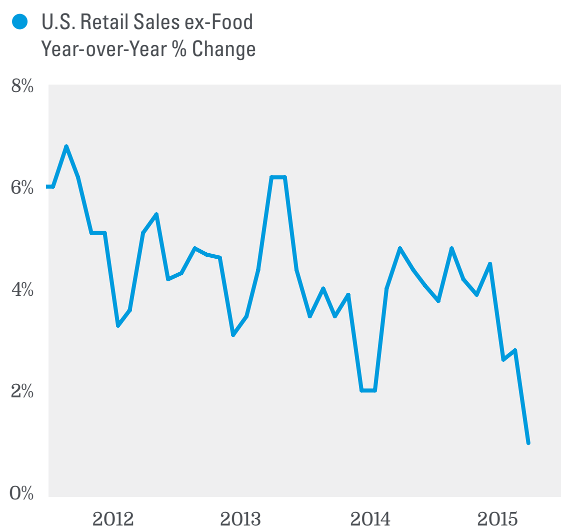
As this publication goes to print, March retail sales will be released. So far, consumers have saved the extra cash generated from lower gas and energy prices rather than spend it, which helps explain lackluster sales growth in early 2015. Retail sales have slowed on an annualized basis [Figure 3] and have been supportive of bonds to start 2015. A strong report may pressure bond prices lower, and vice versa for a weak report.

Low inflation has been supportive of both U.S. and European government bonds for some time [Figure 4]. This week's inflation releases may provide some insight as to whether the deceleration in inflation, or actual deflation in Europe's case, may be in the process of ending.

Investors likely will not get a resolution this week as inflation trends change at a glacial pace; but, given the importance to central banks around the world, these will be closely watched data releases. Several months of data will be needed to confirm any change in inflation trends and provide another reason why bond yields may be range bound over the near term.

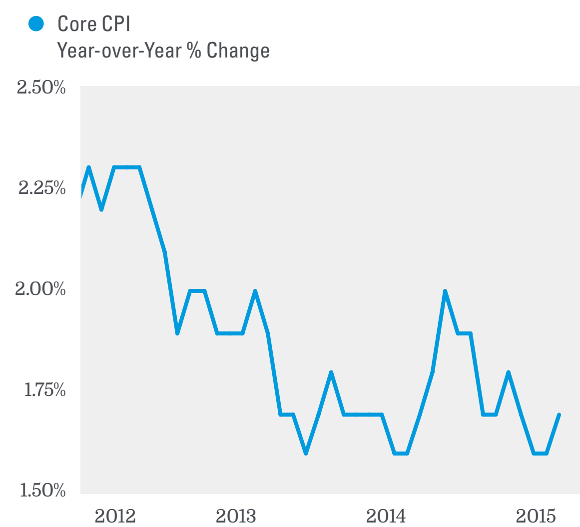
The degree to which these reports meet, exceed, or fall short of expectations will influence whether the recent soft start to the second quarter of 2015 continues. We expect yields to start to move higher in the second quarter, but until more clarity develops, bonds yields may drift at the lower end of their recent range. ■

3 WEAKER RETAIL SALES...



Source: LPL Research, Bloomberg 04/13/15

4 ...AND LOW INFLATION HAVE SUPPORTED BONDS EARLY IN 2015



Source: LPL Research, Bloomberg 04/13/15
Core CPI excludes food and energy prices.

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 reference 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.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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).

DEFINITIONS

The Citigroup Economic Surprise Index is an objective and quantitative measure of economic news. It is defined as weighted historical standard deviations of data surprises (actual releases versus Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beaten consensus. The index is calculated daily in a rolling three-month window.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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