

# Bond Market Perspectives



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## Winding Down

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#### Highlights

Investors typically adopt a conservative tone heading into year-end, a factor that will likely help Treasuries hold onto recent gains.

The success of a new lending operation, or lack of it, may help investors assess how European banks and governments are able to handle a significant refinance burden in 2012.

Treasury prices are likely to stay firm as 2012 begins until clarity emerges around issuers' ability to rollover maturing debt.

Treasuries appear set to finish 2011 on a strong note as prices increased last week and the 10-year Treasury yield fell below 2.0% once again [Chart 1]. European debt fears, not domestic economic data which continue to improve, were once again the main driver of Treasury prices last week and approaching year-end suggests Treasury strength may likely persist.

Year-end is typically a time when investors remain conservative as protection against a negative news headline that could have a more adverse impact than normal due to the light volume trading conditions. Treasuries are likely to hold recent gains and may move higher through year-end due to investor desire to remain safe through light-volume trading that typically accompanies the holiday season. Treasuries have been one of the best investment vehicles to hedge against risks from European debt fears and to maintain a conservative stance through year-end [Chart 2].

Last week, this desire to stay conservative was evident in a robust set of Treasury auctions. All three of last week's conventional auctions—new 3-, 10-, and 30-year Treasury debt—met strong demand, a rare feat. The 30-year Treasury bond auction in particular garnered strong demand. The fact that investors were willing to purchase a long-term, more interest rate sensitive Treasury with such confidence gave the entire Treasury market a lift.

The focus for the coming week and beyond will once again be Europe. This week, the first of the European Central Bank's (ECB) longer-term 3-year lending facility will take place. New ECB president Mario Draghi has refused to unleash the unlimited buying power of the ECB on expanding ongoing bond purchases. While investors have been clearly disappointed in the lack of a more robust response from the ECB, the ECB is hoping that tomorrow's lending operation, which comes with terms that make it easier for banks and financial institutions to borrow, will help alleviate bank funding strains and perhaps even entice banks to buy Spanish, Italian and other European government bonds. For example, one strategy a bank could pursue would entail borrowing from the ECB at 1%, purchasing a 5-year Italian government bond that yields 5.8%, and earning 4.8% interest income from the transaction. With the ECB serving as a backstop, the significant interest income differential could be profitable.

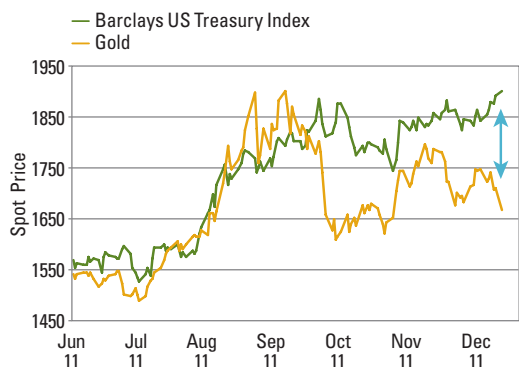
However, it remains to be seen whether European banks would pursue such a strategy or on what scale. Wall Street analysts calculate that banks may tap the credit line for 250 to 500 billion euros. The European Banking Authority recently announced that European banks will be required to boost

#### 1 Treasury Yields Are Likely To Remain Near the Lows of 2011 Through Year-End



Source: Bloomberg, LPL Financial 12/19/11

**2 Treasuries, Not Gold, Has Provided a Better Offset to European Debt Fears**

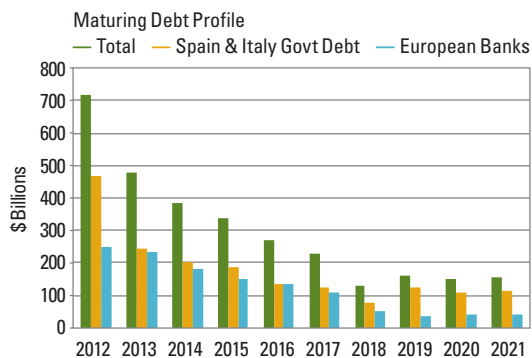


Source: Barclays, Bloomberg, LPL Financial 12/19/11

The Barclays treasury Index is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

**3 Rolling Over Maturing Debt Will Pose a Challenge In Early 2012**



Source: Bloomberg, LPL Financial 12/19/11

Note: European Bank debt profile consists of maturing debt of 11 large European banks (Deutsche Bank, Commerzbank, BNP, Credit Agricole, Societe Generale, Banco Santander, Banco Bilbao, Banco Popular, Unicredito, Intesa San Paolo, and Monte dei Paschi).

minimum capital levels (as a buffer against future losses) by the middle of 2012. Going on a buying binge while minimum capital reserves need to be increased seems counterintuitive. Furthermore, with many European banks unable, or struggling, to issue corporate bonds, increasing holdings of troubled euro-zone government debt may spook investors and therefore prove counterproductive.

Results of Wednesday's 3-year lending operation will therefore be scrutinized closely but it may take a few weeks to reveal the true nature of any increase in borrowing from the ECB. Market action in the days and weeks ahead will provide a better picture of whether ECB proceeds are used to purchase European government bonds or simply hoarded to pay off maturing debt.

Italy and Spain will have to refinance a large amount of maturing debt in 2012 and large European banks share a similar challenge [Chart 3]. Once the New Year begins, Treasuries may hold gains as investors assess the effectiveness of the new 3-year lending operation, which may reveal how successful troubled European government bond issuers handle a significant refinancing need. February through May are the heaviest months of maturing bond proceeds and Treasury yields may stay pinned near record lows in January and February before the challenge of rolling over maturing debt begins in earnest.

We factored the maturing debt challenge into our *2012 Outlook*. While Treasury strength may persist to start 2012, we believe attractive valuations and higher income of corporate bonds may come to benefit investors over the course of the full year. In the meantime, the winding down of year-end is likely to keep Treasury prices firm.

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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.

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

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