July 17 2018

BONDS MAY FEEL CONTINUED PRESSURE

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KEY TAKEAWAYS

Rates may be poised to rise further in the second half of 2018, though likely at a slower pace than the first half of the year.

Investors may benefit from a more active approach to fixed income going forward.

We maintain our year-end forecast of 2.75–3.25% for the 10-year Treasury yield.

As expected, the return of the business cycle and the accelerating economic growth that has accompanied it have combined to push market interest rates higher in the first half of the year. Periods of stock market volatility have resulted in temporary "flights to quality" where investors seek safe-haven assets like U.S. Treasury bonds,* pushing their yields lower and highlighting the diversification benefits of high-quality fixed income within portfolios. However, we continue to believe the long-term fundamental drivers, including economic growth, deficit spending, rising inflationary pressures, and expectations of future Federal Reserve (Fed) rate hikes, may push bond yields marginally higher as the year progresses. Given this back and forth volatility in market interest rates, we encourage suitable investors to employ more active strategies within their fixed income portfolios going forward.

DECIPHERING THE YIELD CURVE SIGNAL

This volatility in market interest rates has been accompanied by a flattening of the U.S. Treasury yield curve, where short-term rates have risen faster than long-term rates. This may eventually lead to an inverted yield curve where short-term rates are above long-term rates. Historically, this has been a negative signal for the U.S. economy, often providing an early warning of an eventual recession. Yet in this circumstance, we believe that the curve flattening with interest rates rising (rather than falling) is a market signal pointing toward future growth.

Please see our *Midyear Outlook 2018: The Plot Thickens* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.

*U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. They 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.

Moreover, a look at the last five cycles shows that the average time it takes from a flattening yield curve (represented by a 0.50% spread between short- and long-term rates) to a recession has been almost four years, with stock prices climbing by an average of 67.9% during that time frame [Figure 1]. Outliers have skewed the average, but a median return of 21.5% is a helpful reminder of the need for investors to maintain a long-term outlook.

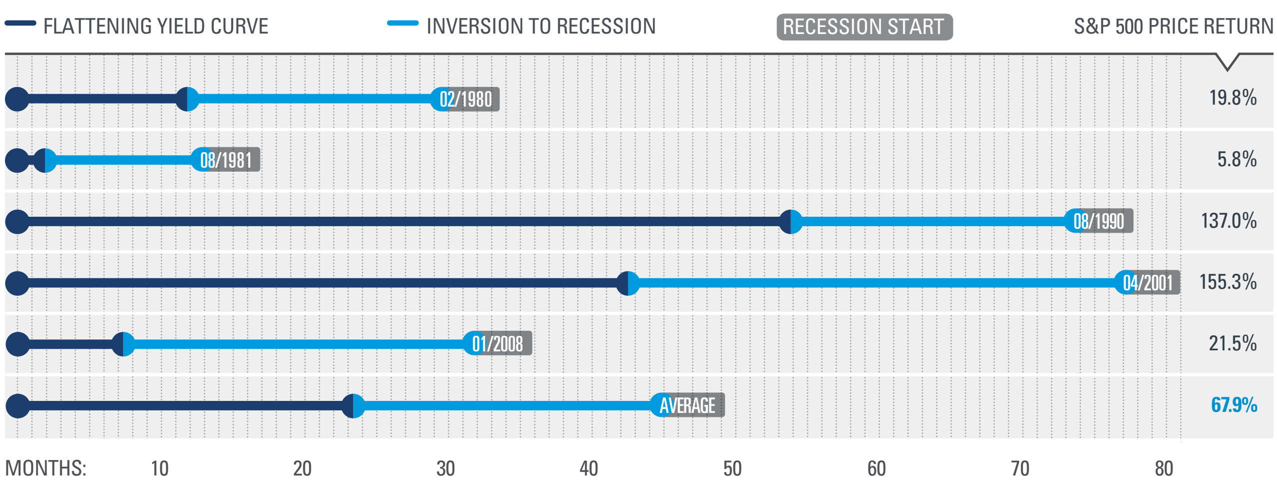
MANEUVERING AROUND THOSE RISING RATES

Considering our recommendation for a more active approach to bonds, it is important to identify how different types of fixed income securities have performed in rising interest rate environments [Figure 2, 3]. As a reminder, we expect yields to grind gradually higher with periodic bouts of volatility, and we maintain our year-end forecast of 2.75–3.25% for the 10-year Treasury. Risks to our forecast include a meaningful upside surprise in inflation or growth, which could pressure rates higher.

U.S. Treasuries: Within the sub-asset classes for bonds, U.S. Treasuries tend to have the most interest rate sensitivity, and historically have performed poorly during Fed tightening cycles. Though increased Treasury issuance to fund federal deficit spending will accentuate this trend, an attractive valuation compared to other sovereign debt may support buying, which should help contain yields.

Investment-grade (IG) corporates: Though investment-grade corporate bonds are also sensitive to a more aggressive Fed, better economic growth is helping to contain the interest rate differentials (spreads) to Treasuries, suggesting investor confidence in their ability to service their debt. Also, to boost this confidence, corporations have gone to great lengths to maintain healthy balance sheets and tighten their income statements during these past several years, evidenced by still low debt-to-earnings ratios. Perhaps more important, the contained spreads collectively indicate a lack of stress in credit markets.

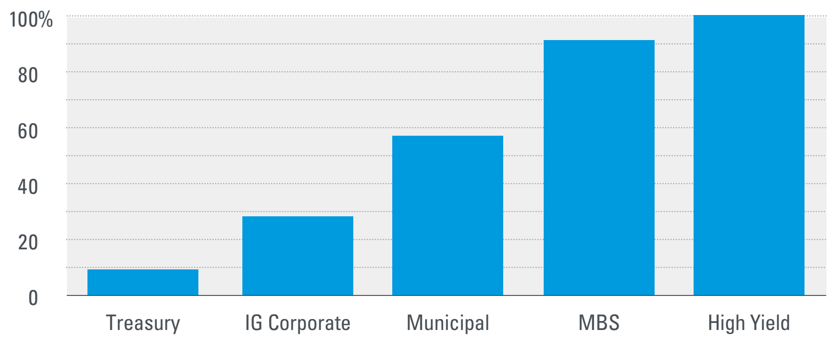
1 A FLATTER YIELD CURVE DOESN'T NECESSARILY MEAN A RECESSION IS AROUND THE CORNER



Source: LPL Research, FactSet 07/17/18
Yield curve steepness in this chart reflects the difference between the 10-year and 2-year Treasury yield.
Flattening yield curve is represented by a 0.5–0% spread between short- and long-term rates.

2 LOWER QUALITY & LESS INTEREST RATE SENSITIVITY REIGN AMID RISING RATES

● How Often Each Asset Class Has Outperformed the Broad Bond Market During Periods of Rising Rates



Source: LPL Research, Bloomberg 07/17/18

The broad bond market is measured by the Bloomberg Barclay's Aggregate Bond Index.

Indexes used: Treasuries: Bloomberg Barclays U.S. Agg Govt; Mortgage-Backed Securities (MBS): Bloomberg Barclays U.S. Agg Securitized; Investment-Grade (IG) Corporate: Bloomberg Barclays U.S. Agg Corporate; High Yield: Bloomberg Barclays U.S. High Yield; Municipals: Bloomberg Barclays Municipal.

Rising rate periods analyzed are those shown in Figure 3.

3 BOND MARKET SEGMENTS VARY IN PERFORMANCE DURING RISING RATE PERIODS

RELATIVE TO THE BROAD BOND MARKET: OUTPERFORMANCE UNDERPERFORMANCE EQUAL PERFORMANCE

					SECTOR				
Rising Rates Start Date	Rising Rates End Date	Length (Months)	10-Year Treasury Yield Change	Broad Bond Market Return	Treasury	IG Corporate	Municipal	MBS	High Yield
09/30/1993	11/30/1994	14	2.5%	-3.5%	-4.3%	-4.9%	-5.9%	-1.5%	2.0%
01/31/1996	08/30/1996	7	1.4%	-1.8%	-2.4%	-2.9%	-0.3%	0.0%	3.2%
11/29/1996	03/31/1997	4	0.9%	-1.5%	-1.9%	-2.4%	-0.7%	-0.4%	1.8%
10/05/1998	01/21/2000	16	2.6%	-2.3%	-4.5%	-3.8%	-2.6%	1.5%	3.7%
11/07/2001	04/01/2002	5	1.2%	-2.4%	-4.8%	-2.8%	-1.5%	-0.5%	4.7%
06/13/2003	09/03/2003	3	1.5%	-4.5%	-6.5%	-6.0%	-4.5%	-1.7%	1.1%
03/16/2004	06/14/2004	3	1.2%	-4.3%	-5.2%	-5.4%	-4.6%	-3.0%	-1.9%
06/01/2005	06/28/2006	13	1.4%	-1.3%	-2.2%	-2.7%	1.0%	-0.1%	5.5%
03/05/2007	06/12/2007	3	0.8%	-1.8%	-2.0%	-2.9%	-1.8%	-1.4%	1.6%
03/17/2008	06/16/2008	3	1.0%	-2.2%	-4.5%	-1.1%	1.0%	-2.3%	6.2%
12/30/2008	06/10/2009	5	1.9%	-0.5%	-7.0%	4.7%	6.2%	1.5%	32.2%
11/30/2009	04/05/2010	4	0.8%	-0.5%	-2.3%	0.8%	1.6%	-0.6%	8.3%
10/08/2010	02/08/2011	4	1.3%	-3.1%	-4.7%	-3.4%	-5.5%	-1.7%	5.0%
09/22/2011	10/27/2011	1	0.7%	-1.7%	-2.8%	-1.1%	-1.2%	-1.1%	3.7%
01/31/2012	03/19/2012	2	0.6%	-1.2%	-2.5%	-0.9%	-1.0%	-0.2%	2.3%
07/24/2012	09/14/2012	2	0.5%	-0.7%	-1.8%	-0.5%	-0.4%	0.2%	4.0%
12/06/2012	03/11/2013	3	0.5%	-1.0%	-1.5%	-1.2%	-1.1%	-0.3%	3.2%
05/02/2013	09/05/2013	4	1.4%	-4.9%	-4.5%	-6.4%	-6.8%	-4.0%	-2.4%
04/17/2015	06/26/2015	2	0.6%	-2.8%	-2.6%	-4.2%	-1.2%	-1.6%	-0.7%
07/08/2016	11/25/2016	5	1.0%	-3.6%	-4.7%	-3.9%	-4.5%	-1.8%	3.7%
09/07/2017	05/17/2018	8	1.0%	-3.3%	-3.9%	-2.6%	-1.0%	-1.2%	-3.4%

Source: LPL Research, Bloomberg 07/17/18

Indexes used are those identified in Figure 2.

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Munis: Higher-quality municipal securities tend to hold up better than Treasuries in rising rate periods, as their tax-exempt status historically attracts investor assets.

MBS: While higher-quality mortgage-backed securities (MBS) have performed well in previous rising rate environments, they are not without their own risks. If rates move significantly higher, fewer homeowners refinance their mortgages at those higher rates, leaving MBS investors with longer maturities than expected, essentially locking in lower interest rates.

High-yield: For suitable investors, other areas of fixed income may enhance yield within diversified portfolios, including bank loans and high yield. With less sensitivity to rising rates, we believe high-yield corporate bonds remain attractive given the combination of income potential and reduced default risk, given solid economic growth prospects. Nonetheless, we encourage investors not to get too enticed by the higher yields, which can often mask other fundamental deficiencies for companies in this space.

DON'T SPEED TOWARD INTERNATIONAL BONDS

Global bonds present a mixed bag of opportunities and risks. As mentioned earlier, U.S. Treasuries remain relatively attractive when compared with other sovereign debt. Global investors may be attracted to the 10-year Treasury yielding near 3.0%, for example, in comparison to the German bund, hovering around 0.50%, or the Japanese government bond, which yields less than 0.05%. Currency translation matters, though, and we continue to favor hedging that risk in developed markets. Emerging market debt yields appear attractive, yet investors should be mindful of escalating trade conflicts.

CONCLUSION

Finally, we want to emphasize that fixed income continues to play an important role in a diversified portfolio. Bonds can provide income and liquidity, and may serve to help manage portfolio volatility during periods of stock market turbulence. We continue to position portfolios with below-benchmark (Bloomberg Barclays Aggregate) interest rate risk, preferring to take credit risk in the current environment. ■

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. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

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.

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

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

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

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

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.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

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 Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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).

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