LPL RESEARCH
BOND MARKET PERSPECTIVES

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WILL YIELDS KEEP RISING?

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KEY TAKEAWAYS

Though risk-off sentiment has dominated news recently and pushed yields slightly lower, yields remain broadly in an uptrend.

Several indicators are saying that the rise in yields may be over for now, or could potentially have gone too far.

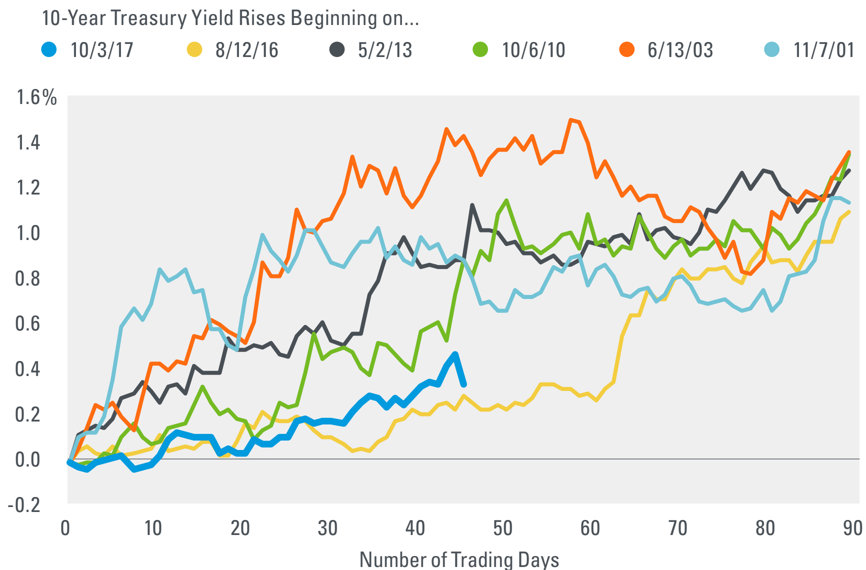
We continue to believe that the 10-year Treasury yield could end 2018 in the 2.75–3.25% range, with some volatility along the way, as growth and inflation continue to move higher.

Yields have started 2018 off on a volatile note, which has been somewhat painful and disconcerting for fixed income investors. The move higher in yields has been to some extent justified (and overdue) in our view. Fundamentals have largely pushed them higher, and a return of volatility (like that seen recently in equity markets) can be looked at as a sign of a healthy, normalized environment where market participants are navigating through complex risks. While the risk-off tone to the market action on February 5, 2018 has brought yields down slightly, the uptrend is still intact and worthy of further investigation.

THE MOVE IN CONTEXT

Though the recent move in yields has been sharp, it certainly has been muted relative to other large moves higher in yields [Figure 1]. With volatility cratering in 2017, sharp moves in equity or bond markets seem more jarring than they have in previous cycles. When viewed in the context of other sharp moves higher in yields, this move is slightly less ominous, however.

1 RECENT YIELD RISE LESS OMINOUS IN CONTEXT OF OTHER UPTRENDS



Source: LPL Research, Bloomberg 02/05/18

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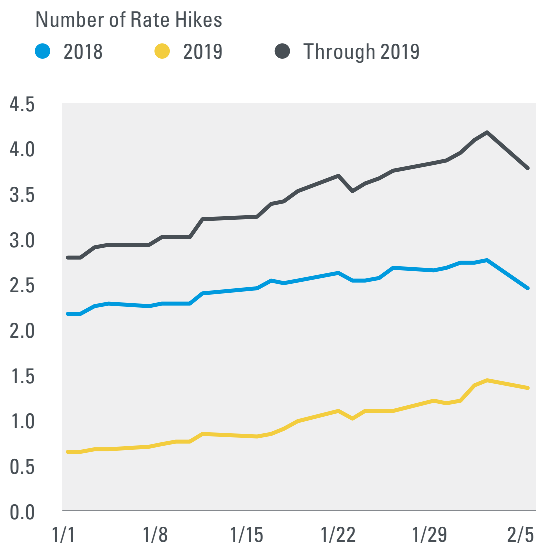
In our view, the pace of weakness in this uptick could be more moderate compared with prior sell-offs, due to the fact the Federal Reserve (Fed) may continue its gradual approach to raising interest rates and inflation is similarly expected to increase gradually. So we find it unlikely that the current sell-off reaches the magnitude of prior sell-offs; however, the lower level of yields combined with lingering price pressures still signals a low-return environment for high-quality bonds in 2018.

SECTOR PERFORMANCE

Year-to-date sector performance is evidence that although the upward trend in interest rates may be pressuring high-quality fixed income, there are opportunities for outperformance relative to the broad market. Our two favored high-quality sectors, mortgage-backed securities (MBS) and investment-grade corporates, have both outperformed the broad Barclays Bloomberg Aggregate Index year to date. Spread tightening within corporates, along with the additional yield relative to Treasuries, has driven that outperformance. MBS boasts yields higher than Treasuries, with significantly less interest rate sensitivity, leading to a favorable risk-reward tradeoff. Treasuries, our least favorite domestic high-quality fixed income sector, possess the dueling headwinds of low yields and high interest rate sensitivity.

2 NUMBER OF EXPECTED FUTURE RATE HIKES HAS CLIMBED YEAR TO DATE



Source: LPL Research, Bloomberg 02/05/18

Market-implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate hike expectations may not develop as predicted.

LONG AND THE SHORT OF IT

The move in Treasury yields has been driven by multiple factors. Shorter-maturity Treasury yields have been pressured higher by rising Fed rate hike expectations. Longer-maturity yields have been driven higher by increasing concerns of a potential upside surprise to inflation and a move higher in real yields. These dynamics are certainly interrelated. The upside surprise to wage growth on February 2, 2018, spooked investors who have grown complacent to low inflation dynamics. This sent yields higher and continued the broad trajectory that yields had been in for weeks. Inflation expectations have been in a meaningful upswing since mid-December 2017.

Rising inflation expectations, and rising measures of actual inflation even more so, may necessitate a more aggressive Fed, which does not want to fall behind a rise in inflation. These dynamics have pressed rate hike expectations up meaningfully over the last month. Looking at expectations for 2018 and 2019 combined, the market has priced in an additional 1.4 rate hikes over the last month alone, from 2.7 at the end of 2017 to 4.2 as of February 2, 2018 [Figure 2]. These expectations have fallen slightly with equity market volatility, but remain elevated from 2017 year-end levels.

While much of this increase is data driven, some of it may be due to expectations for a more hawkish Fed under Fed Chair Jerome Powell, as discussed in our recent *Bond Market Perspectives, "The Fed is Moving Forward"* piece.

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OTHER INDICATORS

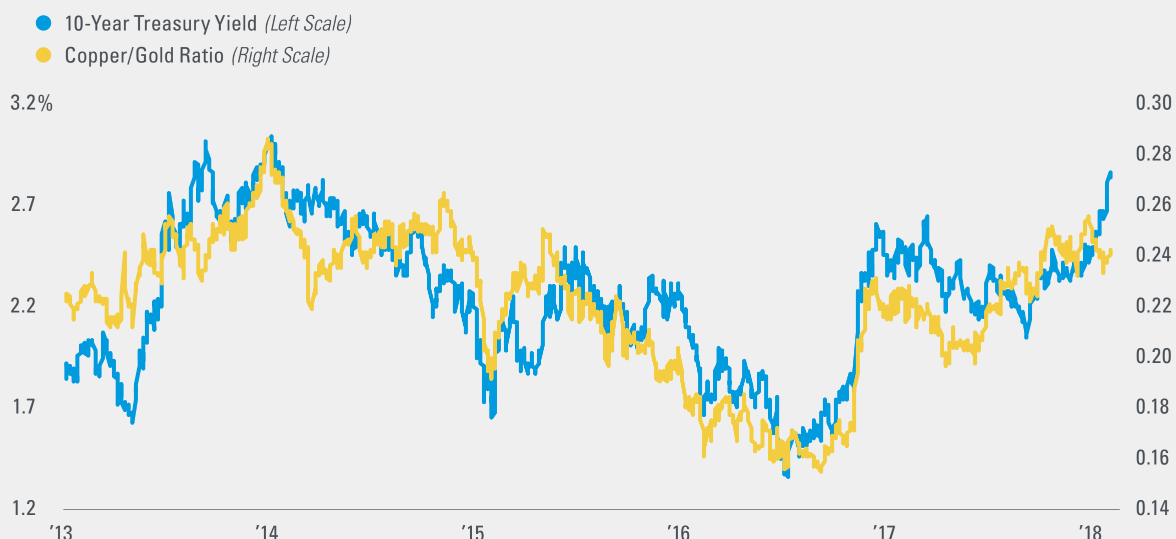
Though this move has been largely driven by fundamentals, there are certain indicators that argue for a pause or perhaps even a slight reversal of yields. The copper/gold ratio has tracked with the 10-year Treasury yield fairly well for the last five years. The rationale behind this comparison is that the price of copper is a harbinger of global economic strength. Because copper is a key input into manufacturing and construction, it is considered to be a useful indicator of global and U.S. economic health. Generally, when copper prices rise, the economy is expanding. This has often led to higher inflation and thus lowers the demand for safe-haven assets such as gold and Treasury bonds.* Based on this relationship, the 10-year's upward run seems a bit overextended [Figure 3].

International dynamics also point to yields potentially pausing here as well. The yield advantage of U.S. Treasuries to other developed nations can be a good indicator of relative value. The investing community is global, and rising domestic yields become very attractive to foreign investors amid yields which are lower in developed foreign markets. The 10-year Treasury's yield advantage to the 10-year German bund is now at 2.08% (as of February 2, 2018), which is its highest in over 10 months. The yield advantage to the Japanese Government Bond (JGB) is even larger.

One important subplot in this dynamic is currency hedging and associated costs. In order to remove currency risk, investors can hedge their currency exposure in the futures markets. If the price of that hedge becomes more expensive, it can eat away at the yield advantage, potentially entirely, making a

*U.S. Treasuries may be considered "safe-haven" investments but do carry some degree of risk including interest rate, credit, and market risk. The price of gold can be affected by developments such as currency devaluations or revaluations, central bank movements, economic and social conditions within a country, trade imbalances, or trade or currency restrictions between countries. There is no guarantee that gold will maintain its value or purchasing power in the future. Gold and other speculative investments are not appropriate for every investor.

3 COPPER/GOLD RATIO INDICATING RATE RISE COULD TAKE A PAUSE



Source: LPL Research, Bloomberg 02/05/18

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global investor indifferent between a U.S. Treasury and a foreign sovereign bond yielding far less. In the case of Japanese investors buying U.S. Treasuries, the recent yield pickup has made Treasuries much more appealing. Japanese investors can now get a meaningful currency-hedged yield pickup relative to the JGB, after that advantage slowly evaporated over the course of 2017.

Treasury auctions can be a good gauge of foreign demand as well. Foreign demand remained strong at the most recent 10-year auction on January 10, and the next auction on February 7, 2018, may be a good indicator of whether increased U.S. yields will spur additional demand from global investors.

CONCLUSION

Though a risk-off tone in equity markets temporarily put the brakes on the upward move in Treasury yields, the upward trend may persist. We continue to believe that the 10-year Treasury yield will end 2018 in the 2.75–3.25% range, with volatility along the way, as growth and inflation continue to move higher and the Fed continues with its gradual pace of data-dependent rate hikes. We maintain that high-quality fixed income is a potential risk mitigation tool within a diversified portfolio. Market action on Monday, February 5, 2018, could serve as a case study for that: The S&P 500 lost 4.1%, while the Bloomberg Barclays Aggregate gained 0.3%, exemplifying fixed income's main role as a ballast for equity market risk. ■

Please see our *Outlook 2018: Return of the Business Cycle* publication for additional descriptions and disclosures.

IMPORTANT DISCLOSURES

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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.

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.

Mortgage-backed securities are subject to credit, default risk, prepayment risk (that acts much like call risk when you get your principal back sooner than the stated maturity), extension risk, the opposite of prepayment risk, and interest rate risk.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features. The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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

INDEX DESCRIPTIONS

The S&P 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 Bloomberg 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).

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