LPL RESEARCH

BOND MARKET PERSPECTIVES

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LONG THE SHORT END OF THE CURVE

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Short-term high-quality bond yields have continued to increase since the lows seen in July 2016, and have moved sharply higher since September 2017.

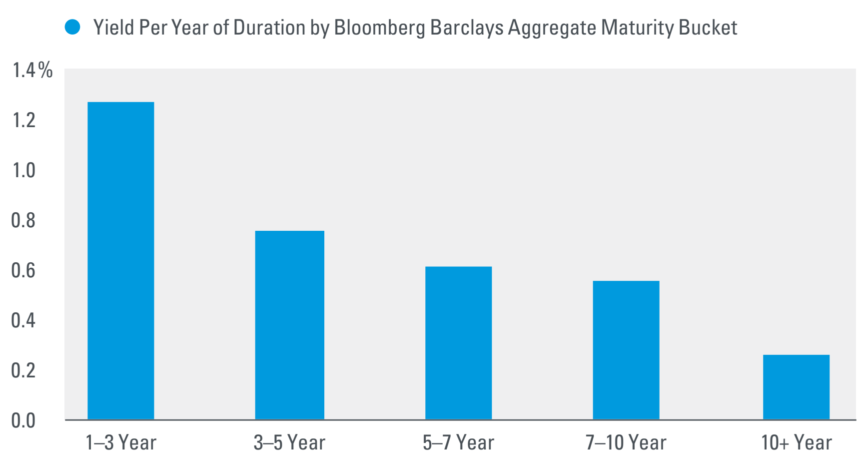
We still prefer intermediate bonds for overall fixed income allocations, but with interest rates on the rise, short-term bonds may present a better risk-reward opportunity for defensive portfolio positioning.

Scenario analysis shows that if rates rise, short-term bonds may outperform intermediate and long maturities.

With shorter-maturity yields increasing as of late, the front end of the yield curve (shorter-maturity fixed income) may be offering an enticing trade-off between risk and reward, and a potential place for investors to play defense. Sector selection and yield curve positioning decisions are difficult in dynamic rising rate environments, but with scenario analysis, we can begin to determine how portfolios may perform in this challenging market.

The Bloomberg Barclays U.S. Aggregate Bond Index ("the Aggregate"), the most widely used high-quality bond benchmark, serves as a good example of the price weakness that has surfaced in fixed income. The index, which is mostly comprised of Treasury bonds, securitized mortgage-backed securities, and investment-grade corporates, saw its yield rise from a low of 1.82% in July 2016, to a high of 3.18% in February 2018. Cheaper prices, coupled with shorter-maturity yields adjusting more drastically to the Federal Reserve (Fed) rate hikes, can present suitable investors with an opportunity to potentially reduce their portfolios' interest rate sensitivity, while not sacrificing a lot of yield, thus playing defense in this volatile market. That defensive positioning can be seen by looking at various maturity segments within the Aggregate in terms of risk versus reward. In this case, looking at the yield of each component, relative to its interest rate sensitivity, shows that shorter maturities currently offer substantially more reward (yield) per unit of interest rate risk (duration) [Figure 1].

1 SHORTER-MATURITY BONDS OFFER ENTICING REWARD VS. RISK TRADE-OFF



Source: LPL Research, Bloomberg 03/16/18

Note: Duration is a measure of interest rate sensitivity of an investment. A bond with a duration of five years will fall approximately 5% in value if interest rates move higher by 1% across the yield curve.

Yields are not representative of any specific investment.

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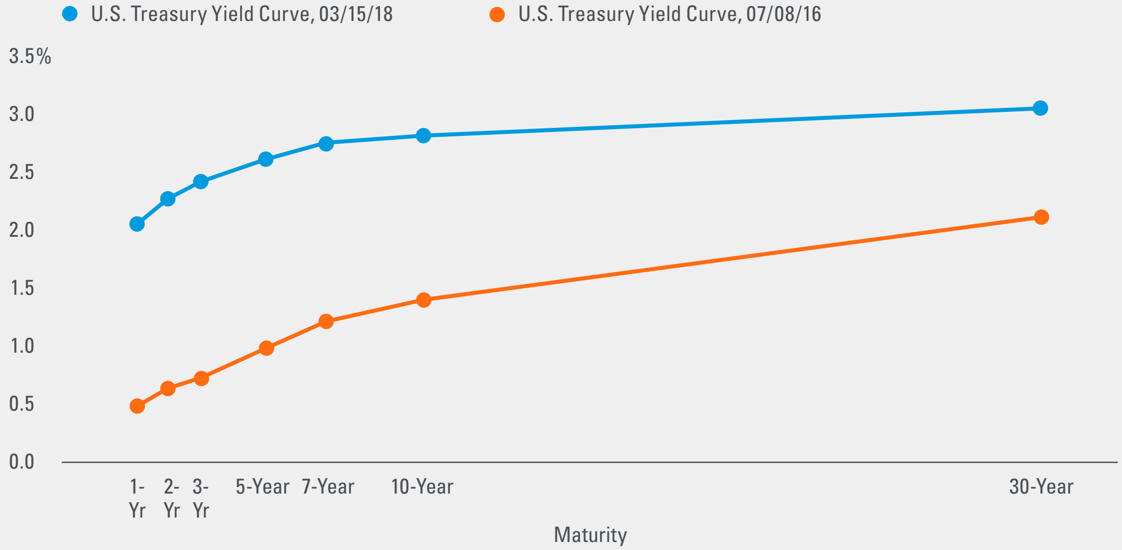
TAKE WHAT THE YIELD CURVE GIVES

Plotting the yields of various maturity bonds generates the "yield curve". The yield curve is considered steep when the line is upward sloping, with long-term yields substantially higher. A flat curve occurs when shorter maturities are closer in yield to the longer ones, causing little incentive for investors to buy longer-maturity bonds. As Figure 2 reveals, in addition to yields moving significantly higher since mid-2016, the Treasury yield curve has flattened meaningfully as well. The higher yields in shorter maturities can make the decision on where to invest on the curve a less difficult one. Investors need not venture out to the more volatile, longer end of the curve for higher returns because the additional compensation does not warrant the added risk. Why invest in a 30-year bond yielding 3.05%, when a 10-year security is offering 2.82%? The same logic can be applied when focusing on 2-year yields relative to 10-year yields. At a 2.28% yield, the 2-year is at its cheapest level (highest yield) since 2008, and investors are only sacrificing 0.54% of yield relative to the 10-year maturity. Our baseline scenario for the Treasury curve is for slightly higher interest rates at all maturities at year-end 2018. In this scenario, investors can take what the curve is giving by targeting shorter-duration bonds if they want to position defensively.

MODELING SCENARIOS

It is difficult to determine appropriate yield curve positioning without a firm opinion on the direction of interest rates. One way to inform the positioning decision is to focus on hypothetical return scenarios. By comparing various maturity segments of the Aggregate and stress testing them for interest rate changes, we can see which maturities might perform best [Figure 3]. The analysis of various subindexes of the Aggregate demonstrates that in a hypothetical scenario when interest rates rise by 0.25%, the 1–3 year section of the index performs

2 **1-YEAR AND LONGER TREASURY MATURITIES OFFER YIELDS ABOVE 2%**



Source: LPL Research, Bloomberg 03/16/18 nearly in line with the 7–10 year bucket over a one-year time horizon. If rates rise by 0.50% across the yield curve, the shortest maturity bucket of the index outperforms all others. This advantage increases as interest rates rise.

It is worth noting that if the opposite occurs and interest rates decline, the scenario analysis clearly favors intermediate- and longer-maturity bonds. If interest rates remain stable or even fall by 0.25%, then longer-term bonds outperform their shorter-term counterparts across the board. This is one of the reasons that for broad fixed income allocations, we prefer the intermediate portion of the yield curve, offering the traditional diversification benefits of high-quality fixed income, without the dramatic interest rate sensitivity of very long-maturity bonds. Considering that the Fed is signaling three additional rate hikes this year, lower rates are less probable and prices have consequently come down on short-term bonds. The experience within shorter maturities is also more consistent, with less chance for dramatic downside or upside, relative to longer maturity bonds, as shown in Figure 3.

CONCLUSION

We expect the trend of gradually higher yields to persist throughout 2018. Bond prices have broadly declined and the front end of the yield curve has adjusted to a potentially more aggressive Fed amid increased growth and inflation expectations. As a result, it now offers considerable risk-reward benefits versus longer-term maturities. We continue to favor more defensive positioning in the 5- to 10-year part of the curve with below-benchmark interest rate sensitivity (duration). This portion of the curve offers the traditional diversification benefits of high-quality fixed income, without the dramatic interest rate sensitivity of very long-maturity bonds. However, for investors with heightened concerns around rising interest rates, shorter maturities offer a potential way to play defense, and may not sacrifice much in the way of yield. Within high-quality fixed income, a diversified allocation to various sectors, including investment-grade corporates and mortgage-backed securities, remains our preferred approach for riding out the volatility of rising interest rates. ■

3 SCENARIO ANALYSIS: VARIOUS MATURITY BUCKETS BEHAVE VERY DIFFERENTLY

Bloomberg Barclays Aggregate Maturity Bucket	Change in Treasury Yield Curve	-0.25%	0.00%	0.25%	0.50%	0.75%
	1–3 Year	2.67%	2.18%	1.69%	1.21%	0.72%
	3–5 Year	3.46%	2.52%	1.58%	0.65%	-0.29%
	5–7 Year	4.49%	3.21%	1.93%	0.65%	-0.63%
	7–10 Year	4.88%	3.32%	1.76%	0.21%	-1.35%
	10+ Year	8.16%	4.42%	0.68%	-3.06%	-6.79%

Source: LPL Research, Bloomberg 03/16/18

Note: Indexes referenced are components of the Bloomberg Barclays U.S. Aggregate Index segmented by maturity. Date represents total return over a one-year period.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

Indexes are unmanaged and cannot be invested into directly.

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.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

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

INDEX DESCRIPTIONS

The Bloomberg 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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