LPL RESEARCH

BOND MARKET PERSPECTIVES

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YIELD CURVE SUBPLOT

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KEY TAKEAWAYS

Context is important for yield curve conversations because not all types of yield curve flattening are the same.

A flattening yield curve with rising rates (a bear flattener) is more indicative of a continued economic expansion than if yields were falling (a bull flattener).

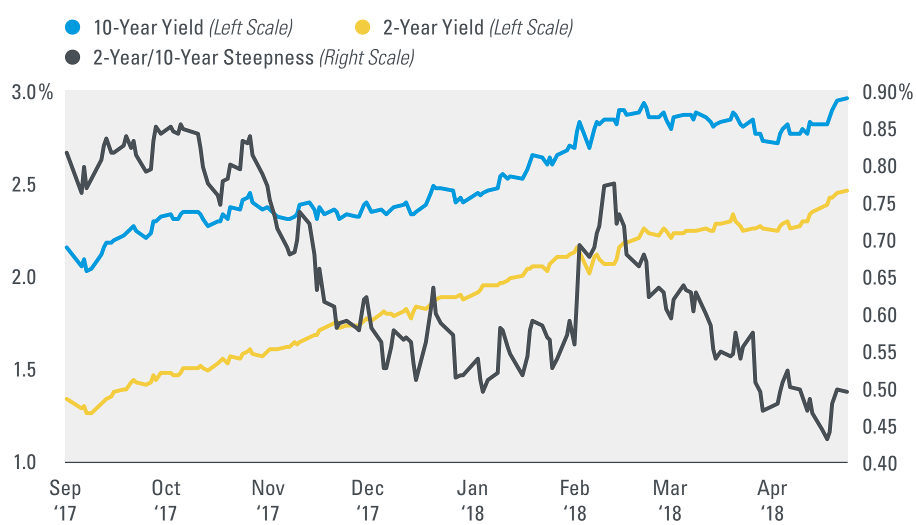
While the yield curve has flattened, it has done so amid rising rates, a more positive indicator for the economy going forward.

The yield curve has continued to flatten; however, because rates are rising simultaneously, it is a less ominous indicator for the economy relative to if yields were falling. Here are two ways in which the yield curve can flatten:

- **A bear flattener** is an environment in which rates rise across the yield curve, but short-term rates rise more so, leading to a flatter yield curve.
- **A bull flattener** is an environment in which rates decline across the yield curve, with long-term rates declining more, also leading to a flatter yield curve.

The bull and bear distinction reflects whether the move is good or bad for bonds, thus a flattening curve with declining yields is bullish, because as yields decline, high-quality bond prices generally rise. A bull flattener is a more worrying indicator. What we have experienced throughout 2017 and year-to-date 2018 is a bear flattener, so although the yield curve has been flattening, it is doing so in a way that appears to lend support to equities and a continuation of the current economic cycle [Figure 1].

1 YIELD CURVE HAS BEEN FLATTENING, BUT YIELDS HAVE BEEN RISING



Source: LPL Research, Bloomberg 04/23/18

2-Year and 10-Year U.S. Treasuries represented.

Performance is historical and no guarantee of future results.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

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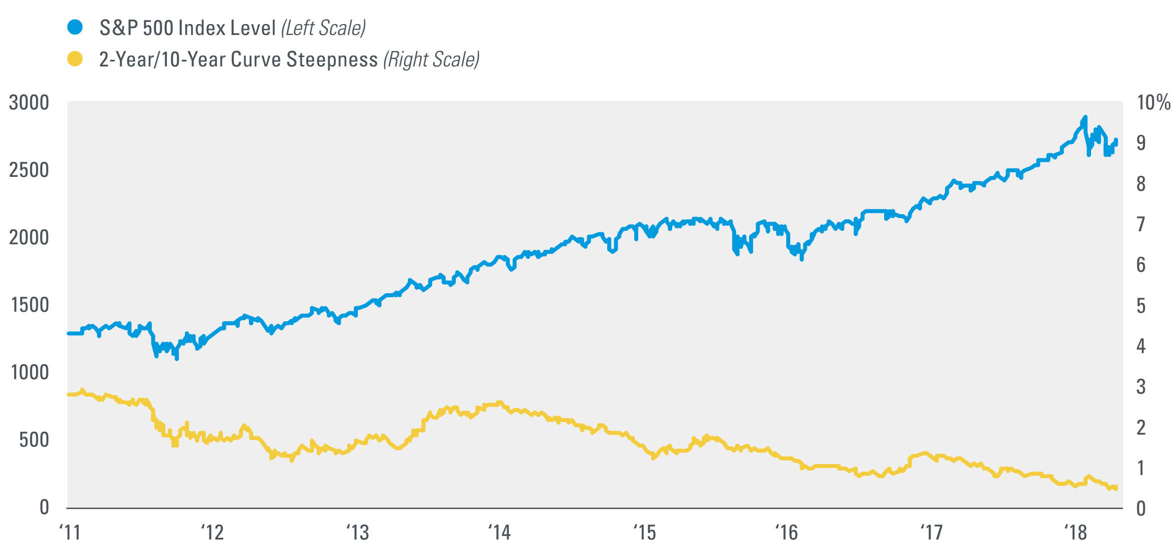
PREVIOUS FLATTENING EPISODES

Much of the concern about yield curve flattening occurs because the yield curve flattens on its way to inversion. An inverted yield curve has historically been a good indicator of recessions, having preceded each of the last nine recessions going back to 1955. On average, an inversion has led the subsequent recession by about five quarters; in the most recent recession in 2008, it was eight quarters. We previously discussed why this indicator may not have quite the efficacy it once did, due to global central bank intervention suppressing long-term interest rates. Additionally, the yield curve remains quite a distance from actually inverting. As a result, the yield curve is not overly concerning at this time, though it warrants ongoing monitoring.

Looking back at the two most recent prolonged bouts of equity market weakness, the first nine months of 2011 and the nine months starting in mid-2015, the yield curve had been flattening as well [Figure 2]. These recent occurrences were bull flatteners, however. This also confirms our belief that the type of flattening is extremely important context in the conversation about a flattening yield curve.

It is important to remember why yields change at various segments of the yield curve. Federal Reserve (Fed) policy and changes to the fed funds rate generally influence short-term yields, while growth and inflation expectations tend to drive longer-term yields. In a solid economic expansion, growth and inflation expectations tend to rise, as they are today. As a result of increasing levels of economic growth, the Fed may hike interest rates in order to keep the economy in check and not let inflation get meaningfully higher than its 2% target. If those short-term yields rise more than longer-term rates, the curve is flattening, but none of the factors driving it are inherently negative.

2 RECENT EQUITY MARKET WEAKNESS ACCOMPANIED BY BULL FLATTENERS



Source: LPL Research, Bloomberg 04/23/18

2-Year and 10-Year U.S. Treasuries represented.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

The S&P 500 is an unmanaged index and cannot be invested into directly.

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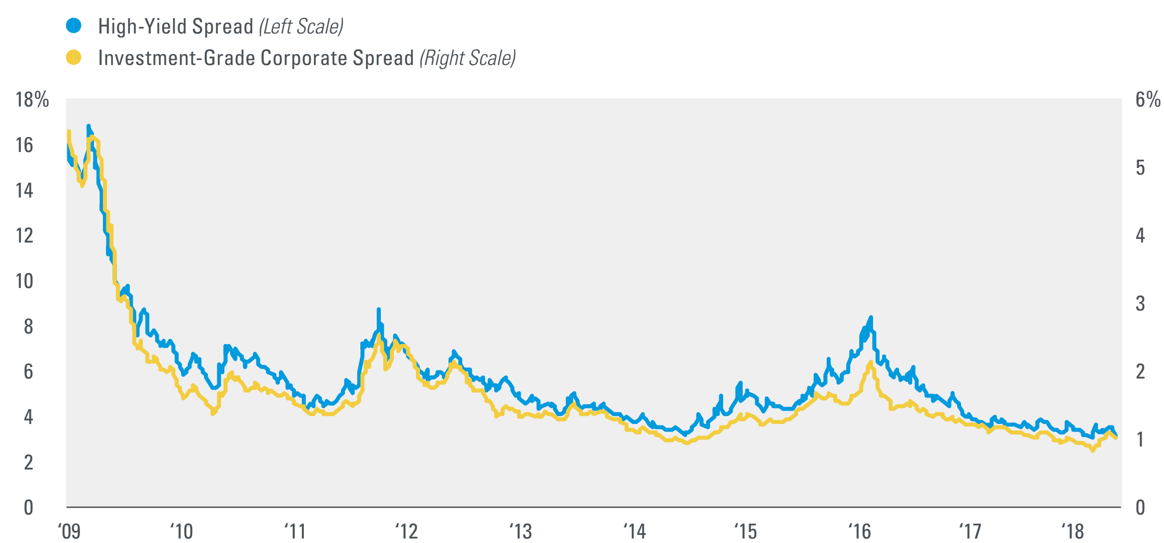
CREDIT CORROBORATION

Another notable fixed income indicator that can be meaningful for stocks are credit spreads, which represent the additional yield over Treasuries that investors demand in order to take on the default and liquidity risk of lower-quality bonds. If a flattening yield curve were portending something ominous, like an imminent recession, one would expect credit spreads to widen, as investors expect an increase in defaults. Credit spreads, however, have been tightening for virtually all of the most recent period of flattening [Figure 3].

CONCLUSION

The yield curve remains an important indicator of investors' views on growth, inflation, Fed policy, and the proximity of the next recession. An inverted yield curve has preceded all recent recessions, so its flattening has logically received heightened interest from market participants. The nature of the yield curve flattening is an essential subplot, yet it does not receive as much attention as it should. A flattening yield curve with yields rising across the curve has been a better backdrop for equities and other risk assets as of late. While the yield curve certainly warrants ongoing monitoring, we do not currently see it as a warning sign from markets that the economic cycle's end may be imminent. ■

3 CREDIT SPREADS CORROBORATE A LACK OF RECESSION CONCERN



Source: LPL Research, Bloomberg 04/23/18

Performance is historical and no guarantee of future results.

High-yield and investment-grade (IG) corporate spreads in this chart represent the yield differential between the average yield of high-yield bonds, or IG corporate bonds, and the average yield of comparable maturity Treasury bonds. Performance is historical and no guarantee of future results.

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.

Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

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.

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.

High-yield/junk bonds (grade BB or below) are not investment-grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

DEFINITIONS

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the 3-month, 2-year, 5-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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.

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