LPL RESEARCH

BOND MARKET PERSPECTIVES

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RATES' NEW RANGE

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KEY TAKEAWAYS

We believe the rise in rates over the last six months represents a healthy repricing of higher growth and inflation expectations, and has the potential to stick.

Though uncomfortable initially, higher yields are generally a positive sign for investors.

We don't believe yields will move precipitously higher from here, but they may gradually increase over the remainder of the year, with volatility along the way.

Rates have moved meaningfully higher over the last six months, which may have been jarring for fixed income investors, who grew accustomed to low and steady yields. The 10-year Treasury yield rose 0.83%, with an impressive move from 2.04% on September 7, 2017 to 2.87% on March 2, 2018. The yield flirted with surpassing the 3% level in late February, closing as high as 2.95%. However, the action was not limited to long-term yields. The 2-year Treasury yield has also been on the move from 1.26% on September 7, 2017 to 2.24% on March 2, 2018, increasing 0.98%. The increase in yields across maturities is, in our view, a healthy repricing of growth and inflation expectations given the current economic backdrop, and thus may mark the beginning of a new range for Treasury yields.

RISING RATES' WRATH

That rise has created discomfort for high-quality fixed income investors. For the six months ending February 28, 2018, the total return on the high-quality Bloomberg Barclays U.S. Aggregate Index was -2.2%. Since the inception of the index in 1976, only 3.5% of all six-month rolling periods (using daily data) have been worse than that from a total return perspective. Low yields were responsible for this in two important ways:

1. Yields that are depressed relative to economic fundamentals can be repriced quickly by markets when forced to, as was evident in this latest move, in the face of an upside surprise in growth or inflation.
2. There is less yield to help protect investors from rising rates. Had the Bloomberg Barclays Aggregate yielded 8% when the rise in rates occurred, investors may have had a positive return over the last six months. However, because the yield is so low (just 3.1% even after the recent pickup), investors had little cushion.

WHAT'S DIFFERENT NOW?

The taper tantrum, which resulted in the dramatic run-up in yields in 2013, can serve as a benchmark for quick increases in rates. From May 2, 2013, to September 5, 2013, the 10-year Treasury yield rose from 1.63% to 3.00%,

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nearly doubling the increase in the market's most recent move. The taper tantrum occurred because investors were concerned that the Federal Reserve (Fed) would imminently taper, or reduce, the amount of money it was pumping into financial markets via quantitative easing (QE), in which the Fed buys Treasury bonds in the open market to keep interest rates low. In hindsight, this was an overreaction by the market, as accommodative monetary policy continued for years after that. Many of the forces behind the taper tantrum, though misinterpreted at the time, are also dynamics that are currently pressing yields higher globally.

Rising levels of inflation are often cited as the catalyst of the recent pickup in yields. That has definitely contributed to the rising rate dynamic, but real yields (yields that are adjusted for inflation) have been trending higher as well [Figure 1].

Rising real yields are a sign that monetary policy tightening is finally gaining steam. Additionally, the increase can be seen as a larger cushion to compensate investors for a potential upside surprise in real growth rates, or a more aggressive Fed than currently anticipated.

LONG-TERM RISE IN SHORT-TERM YIELDS

Rates have been moving higher at shorter maturities as well, led by a more aggressive anticipated path of rate hikes by the Fed, due to increasing levels of growth and inflation domestically with a strong international economic backdrop. Rising inflation expectations, and even more so, rising measures of actual inflation, may necessitate a more forceful Fed (as the Fed does not want to respond to rising inflation too slowly). These dynamics have pressed rate

1 REAL YIELDS MAY HAVE BROKEN TO UPSIDE AFTER MULTI-YEAR DOWNTREND

Source: LPL Research, Bloomberg 03/05/18

Performance is historical and no guarantee of future results.

Real yield displayed is the inflation-adjusted yield of the 10-year U.S. Treasury bond.

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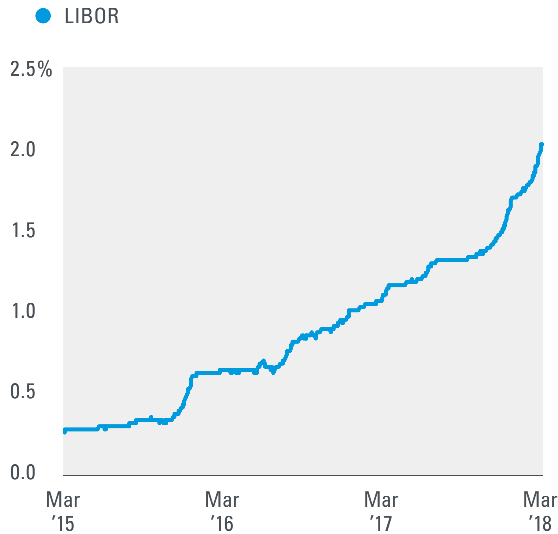
hike expectations—and thus, short-term yield measures like the London Interbank Offered Rate (LIBOR)—up meaningfully over the last six months [Figure 2]. In fact, LIBOR has climbed past 2% for the first time since 2008.

2 LIBOR INCREASE HAS ACCELERATED RECENTLY WITH MORE AGGRESSIVE RATE HIKE EXPECTATIONS



Source: LPL Research, Bloomberg 03/05/18

London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market.

Less monetary policy accommodation is not a uniquely domestic issue, however. The European Central Bank (ECB) could continue winding down its own QE program this year, though the ECB could potentially keep rates low and provide reduced accommodation thereafter. Fears that the Bank of Japan could lower monetary support amid stronger growth may also put upward pressure on rates, not only in Japan, but globally as well.

CONCLUSION

For all of the aforementioned reasons—stronger growth and inflation readings, a healthy economic backdrop globally, and waning central bank support—we believe the recent rise in yields has the potential to last. We also don't expect rates to move dramatically higher, but they may gradually increase, with volatility along the way. We continue to expect that the 10-year Treasury yield will end the year within our target range of 2.75 to 3.25%.* In general, individual investors receive more in interest than they pay, making rising rates uncomfortable at first, but ultimately helpful in addressing long-term investment goals. ■

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

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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.

DEFINITIONS

Tapering refers to the Federal Reserve (Fed) slowing the pace of bond purchases in their Quantitative Easing (QE) program. To execute QE, the Fed purchases a set amount of Treasury and mortgage-backed bonds each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth. Lowering the amount of purchases (tapering) would indicate less easing of monetary policy.

Quantitative easing (QE) is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association. The Libor is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

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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