LPL RESEARCH

BOND MARKET PERSPECTIVES

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WHO HAS IT RIGHT?

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KEY TAKEAWAYS

Stock and bond markets appear to be telling different stories about the U.S. economy, with stock prices climbing and bonds holding relatively steady.

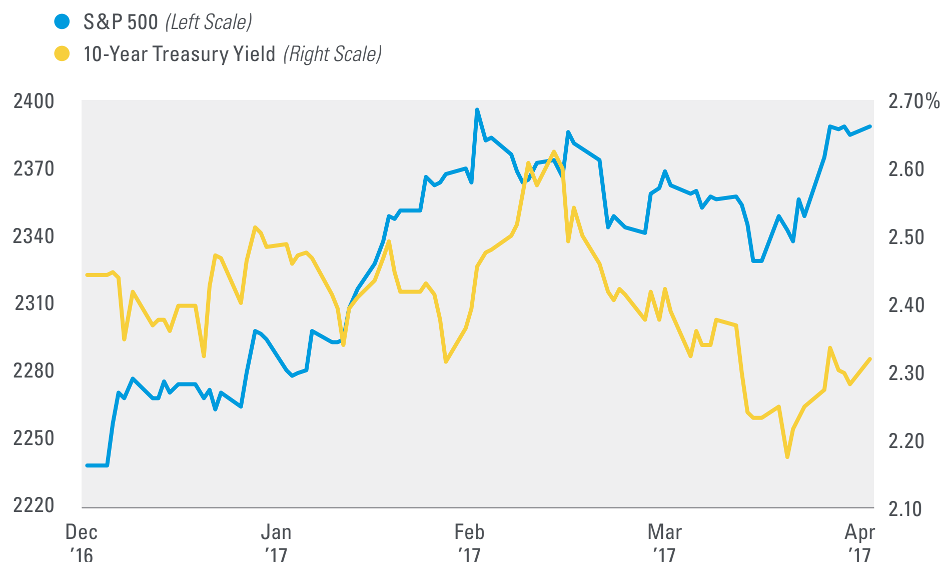
Yields may drift higher in the near term, but we do not believe this marks the start of a steady and sharp run higher in interest rates.

A sluggish growth environment and lack of inflation fears may give the Fed pause in raising rates more than three times in 2017.

Stock and bond markets may continue to settle their differences in May, resulting in slightly higher yields. In recent weeks, stock and bond markets have taken divergent views of the macro investment landscape. While stocks, as measured by the S&P 500 Index, are hovering near all-time highs, bond market prices, which typically move inversely to stock prices, instead moved higher with the 10-year Treasury yield dropping to 2.18% on April 18, 2017. Rates have crept higher since then, but the 10-year Treasury yield close of 2.32% on Monday, May 1 remains nearly 30 basis points lower than the year-to-date high of 2.61% reached on March 13, 2017. Higher bond prices, despite strong performance in the stock market, have many wondering which market has it right, stocks or bonds.

Stock volatility, as measured by the CBOE Volatility Index (VIX), has been low all year, signaling that investors do not appear to be very worried about near-term volatility in the S&P 500. Consequently, Treasury prices moved lower through mid-March. This typical reaction of lower bond prices in response to equity

1 STOCK PRICES AND BOND YIELDS HAVE DIVERGED YEAR TO DATE



Source: LPL Research, FactSet 05/01/17

Performance is historical and no guarantee of future results.

The S&P 500 is an unmanaged index which 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. Past performance is no guarantee of future results.

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strength reflected the bond market's belief that the Trump administration's pro-growth agenda was on course. Yields, as measured by the benchmark 10-year Treasury, rose; however, the higher yields were short lived as the yield curve, somewhat counterintuitively, flattened immediately after the Federal Reserve (Fed) raised rates in mid-March. Although the Fed move had some impact, the reaction to the Republicans' withdrawal of the healthcare legislation reform bill may also have led some traders to believe pro-growth policies, such as tax reform, may be delayed. Since then, many bond market participants have become skeptical of the Trump agenda and although the stock market is rallying, bond prices have not declined. The divergence between stock and bond markets is illustrated in Figure 1, where falling yields year to date have contrasted with higher stock prices.

FACTORS AFFECTING INTEREST RATES

The economic calendar is busy this week, highlighted by Friday's Nonfarm Payrolls report for April. In addition, the Federal Reserve's policy meeting is underway (May 2-3). These events, together with increased supply, may determine the path of near-term bond yields.

Yields have drifted higher recently and may continue to, but we do not believe this marks the start of a steady and sharp increase in interest rates. In our view, in addition to geopolitical risks in Syria and North Korea, several other factors continue to argue for a low-yield environment that is broadly range bound:

- **Inflation fears are contained.** Inflation expectations, as measured by the difference

2 INFLATION EXPECTATIONS HAVE DECLINED IN RECENT WEEKS

Source: LPL Research, FactSet 05/01/17

Treasury Inflation-Protected Securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI). Therefore, the difference between Treasury yields and TIPS yields is used to represent implied inflation expectations.

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between the 10-year Treasury yield and the 10-year Treasury Inflation-Protected Securities (TIPS) yield, have declined since the start of the year as a result of the yield curve flattening after the Fed raised short-term rates in March [Figure 2]. Inflation, higher or lower, is one of the primary drivers of bond yields. Lower inflation expectations may at times signal that the market is pricing in less economic growth. The increase in bond prices more recently suggests lower inflation risk. Without more tangible market signs that rising inflation will be a threat, the risk to a steady and pronounced bond market sell-off is diminished.

- **U.S. and Chinese economic data are showing signs of weakness.** The recently reported Q1 2017 gross domestic product (GDP) number came in at 0.7%, well below the 2.5% pace in Q4 2016. In addition to slower growth in the U.S., after a strong Q1 2017, China, the second-largest economy behind the U.S., reported lower than expected manufacturing Purchasing Managers' Index (PMI) data in April. Services data in China, as represented by the non-manufacturing PMI, also dropped slightly for the same time period (from 55.1 in March 2017, to 54.0 in April 2017). These data misses in China, coupled with recent economic misses in the U.S., may lead to lower inflation globally if the weakness persists.
- **The European Central Bank (ECB) and Bank of Japan (BOJ) remain accommodative.** Though it tapered the pace of purchases from 80 billion euro per month to 60 billion, the ECB remains committed to continuing its bond-buying program, thus keeping short-term rates down in Europe. The program effectively puts downward pressure on U.S. yields by keeping overseas yields artificially low. The BOJ lowered their inflation forecast last week, indicating their stance will likely remain accommodative in the near term as well. As a result, U.S. yields remain low as global investors buy high-quality U.S. bonds at cheaper prices. For example, without the support from the ECB, the market would pay less for the lower-rated Spanish 10-year government bond, as it holds more risk than the higher rated U.S. Treasury. Investors, however, can buy the higher-quality, lower-risk U.S. bond at a 2.32% yield, versus 1.63% for the Spanish bond, thus picking up a higher-quality bond with 69 basis points of additional yield. As long as major global central banks remain accommodative, it may be difficult for U.S. yields to move substantially higher.

CONCLUSION

The performance of the stock market has been impressive so far this year. This, coupled with still-low bond yields, may lead some to believe that the bond market is ripe for a pullback (higher yields), yet yields haven't moved notably higher in recent weeks. We expect the 10-year Treasury yield may move moderately higher over the course of 2017 and continue to believe that our year-end target range of 2.25% to 2.75%, with the potential for as high as 3% if the administration moves forward with meaningful fiscal stimulus, remains reasonable.* Until then, all eyes are on both the stock and bond markets to determine which will end up getting it right. Only time will tell. ■

*We expect the 10-year Treasury yield to end 2017 in its current range of 2.25 – 2.75%, with a potential for 3%. Scenario analysis based on this potential interest rate range and the duration of the index indicates low-to-mid single digit returns for the Bloomberg Barclays Aggregate Bond Index.

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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.

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.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk and opportunity risk. If interest rates rise, the value of your bond on the secondary market will likely fall. In periods of no or low inflation, other investments, including other Treasury bonds, may perform better.

Stock investing involves risk including loss of principal.

DEFINTION

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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.

CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Purchasing Managers Indexes are economic indicators derived from monthly surveys of private sector companies, and are intended to show the economic health of the manufacturing sector. A PMI of more than 50 indicates expansion in the manufacturing sector, a reading below 50 indicates contraction, and a reading of 50 indicates no change. The two principal producers of PMIs are Markit Group, which conducts PMIs for over 30 countries worldwide, and the Institute for Supply Management (ISM), which conducts PMIs for the U.S.

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