LPL RESEARCH

BOND MARKET PERSPECTIVES

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THE IMPACT OF 3%

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KEY TAKEAWAYS

The 10-year Treasury yield recently crossed the psychologically important 3% level for the first time since December 2013.

For investors, this means that Treasuries are more attractive than they have been in some time, though rates are still low relative to longer-term averages.

Corporate profits remain strong, and coverage of interest payments is not yet a concern for most companies.

The 10-year Treasury yield has been hovering between 2.8% and 3.0% for months, but finally closed at 3% on May 9, 2018. Since then, the benchmark rate has fallen slightly, though it remains in a tight range around the 3% level. So what does a 3% yield mean for markets? A round number like 3% can be psychologically important for markets, and does represent a more attractive yield for high-quality bond investors than they may be used to. However, it is also important to keep in mind that the impact of such a move, for both investors and borrowers alike, is limited, given that a 3% yield isn't markedly different from the 2.8–3.0% range that the 10-year has experienced since February.

HIGHER YIELD FOR HIGH QUALITY

As little as two years ago, a 3% yield on a high-quality bond like a 10-year Treasury was a bit of a pipe dream. The 10-year yield bottomed at 1.36% on July 8, 2016. Rates moved higher over the remainder of the year, and saw a major bump following the 2016 election as markets started to price in the likelihood of fiscal stimulus. Rates struggled to move higher through most of 2017, though higher expectations for growth and inflation following the tax bill, as well as the prospect of additional Treasury supply, helped rates move higher late in the year and in early 2018.

So what does all this mean for investors? Since the financial crisis, income-oriented investors have had a dilemma. With yields on high-quality assets so low, some have had to invest in lower-quality assets to support their income needs. While a 3% yield is still low relative to history and may not be high enough to meet the needs of all investors, it is definitely a move in the right direction for savers. Figure 1 shows the amount of Treasury holdings needed in order to generate a $100,000 annual income stream.

The average yield on the 10-year Treasury over the last 50 years (since May 15, 1968) has been just over 6.4%. At that rate, an investor would need to hold just under $1.6 million in Treasuries in order to generate $100,000 of income per year. In July 2016, at a rate of 1.36%, this number grew to nearly $7.4 million. Today, with a 10-year yield of 2.99% (as of March 14, 2018), that number has dropped to $3.3 million. While this number is still out of reach for many investors and higher than the historical average, it does show the impact higher yields can have for investors. It is also important to note that Federal Reserve (Fed) rate hikes have driven short-term rates higher as well. Investors could purchase $3.9 million of 2-year Treasuries that currently yield 2.56% (with significantly lower interest rate risk [duration]) to generate the same $100,000 of income.

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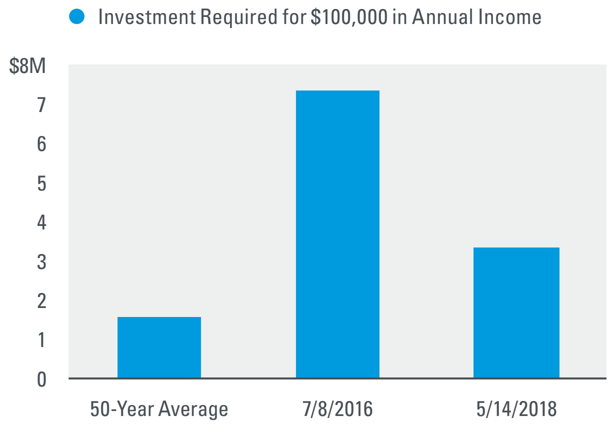
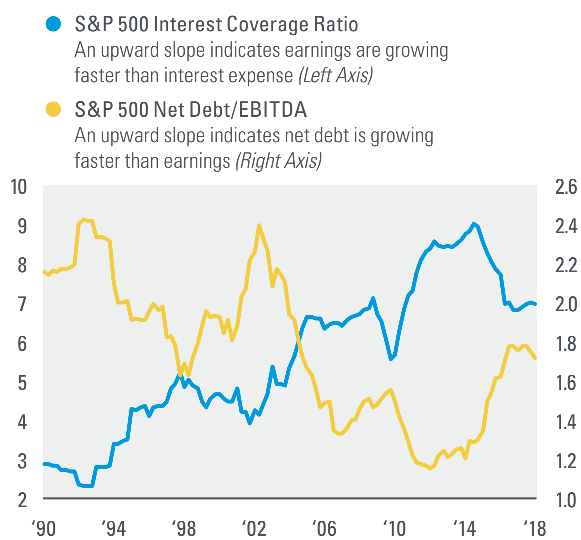
1 **THE AMOUNT OF 10-YEAR TREASURIES NEEDED TO GENERATE $100,000 OF ANNUAL INCOME**



Sources: LPL Research, Bloomberg 05/15/18

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

2 **WHILE CORPORATE LEVERAGE HAS INCREASED, INTEREST COVERAGE REMAINS STRONG**



Sources: LPL Research, FactSet 05/15/18

Net debt is calculated by subtracting cash equivalents from short- and long-term debt.

EBITDA refers to earnings (or net income) before interest, taxes, depreciation, and amortization.

The S&P 500 is an unmanaged index which cannot be invested into directly. Past performance is no guarantee of future results.

WHAT HIGHER YIELDS MEAN FOR BORROWERS

Record-low yields in recent years have made borrowing more attractive for both consumers and companies. As Figure 2 shows, S&P 500 Index companies have taken advantage of low rates by issuing more debt. As a result, the ratio of debt to earnings increased. Though this ratio has fallen slightly in recent quarters, at least in part due to strong earnings (see our first quarter earnings update), it remains near pre-crisis levels last seen in 2003. However, it is also well below levels seen in the early 1990s and 2000s.

Additionally, the interest coverage ratio, a measure of how many times operating earnings before interest and taxes (EBIT) covers interest expense, remains strong. This number could start to slip as companies refinance debt at higher rates in the future, but with a coverage ratio of nearly seven, the average S&P 500 company has a long way to go before it needs to be worried about not being able to cover interest expenses.

CONCLUSION

The 10-year Treasury yield continues to hover near the 3% level, a major milestone for markets that have been accustomed to lower rates in recent years. Higher rates mean investors may have an easier time meeting their income goals with high-quality bonds. However, as attractive as a 3% yield is relative to the historically low rates experienced in recent years, it is still low relative to the long-term historical average and unlikely to meet all the needs of many investors. But on the positive side, it also seems unlikely to cause major pain for corporate borrowers in the near term.

Higher growth and inflation expectations have been major factors in driving rates to current levels, as has increased Treasury supply. We believe that markets may be pricing in much of the impact of these factors at this point in time, and that rates may trend sideways in the near term, outside of a move higher for inflation or any major policy changes from the Fed or other global central banks. We continue to expect that the 10-year Treasury yield may end 2018 within a range of 2.75–3.25%.* ■

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

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.

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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.

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.

Treasuries represent a marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

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.

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.

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