LPL RESEARCH

BOND MARKET PERSPECTIVES

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TRADE FEARS INCH HIGHER

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KEY TAKEAWAYS

Segments of fixed income more vulnerable to trade tensions have faced more pressure than more domestically focused areas.

Protectionist trade policy fears have weighed on IG corporates, as the global footprint of larger companies could be a liability if trade tensions escalate.

We believe a full-scale trade war will be averted and negotiation remains the likely path forward.

Although we believe investors will be spared an all-out trade war, spreads across fixed income sectors are pointing to heightened trade concerns. Spreads have widened since February across many sectors of fixed income like high-yield and investment-grade (IG) corporates, emerging market debt (EMD), and others, but the differences in patterns in various asset classes indicate that those market segments most affected by potential protectionist trade policies have been hit the hardest by spread widening in recent months.

CORPORATE CONTRAST

One comparison that illustrates the weight of worry regarding trade policy is recent spread behavior in different segments of corporate bonds. Investment-grade corporate bonds are those of higher-rated issuers, usually larger, more established companies that are less likely to have problems repaying debt obligations than lower-rated issuers. The companies also generally have more of a global footprint than smaller, lower-rated companies; which is usually an advantage, as these companies can more easily expand to new markets internationally, diversify their income streams across continents, and potentially weather economic downturns better if other regions of the world outperform the U.S. economy.

However, in certain contexts, that global footprint can become a liability. Trade concerns could be putting more pressure on these companies relative to smaller, more domestically focused companies that make up the lower-quality, high-yield corporate bond index. This may be partially why spreads are widening in IG corporates relative to high yield [Figure 1], indicating investors are demanding more of a pickup in yield premium. Spreads at the sector level within the IG corporate universe confirm this. In the past two months, as trade concerns have accelerated, spread widening has been more pronounced in industrials relative to other sectors of the index (as a percentage of starting spread level above comparable maturity Treasuries).

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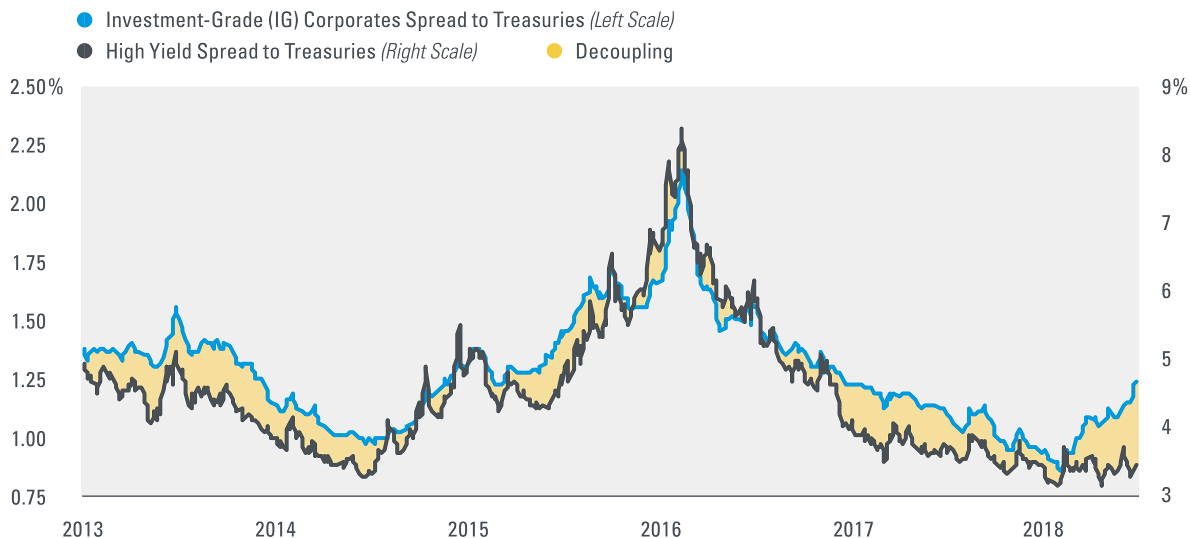
Of course, there are other valid reasons why IG corporate bonds have weakened relative to high yield. One is interest rate sensitivity, which is higher in the IG sector than the broad high-quality market. Another is issuance, which has been higher than expected this year, and may pick up due to elevated merger and acquisition activity brought to bear by lower regulatory hurdles in the Trump administration's focus on deregulation and significant corporate cash stockpiles. More supply can create negative technical pressure and press spreads higher. IG supply could wane in the upcoming summer lull or at the start of the second-quarter corporate earnings season, which could help the market firm and potentially recoup some of the spread widening experienced over the last four months.

INTERNATIONAL PERSPECTIVE

One asset class that has also been under pressure due to heightened trade fears is emerging market debt (EMD). For the last several years, we have remained defensive regarding international fixed income exposure. This not only applied to high-quality sovereign debt, due to low yield levels, but to lower-quality EMD as well (though EMD has a broad range of quality ratings). The reason for our defensiveness was similar return expectations within high yield, bank loans, and EMD. With EMD, however, there is the additional risk of currency fluctuations, unless a currency-hedged product is used.

Additionally, we understood that, in line with President Trump's campaign rhetoric, there was the potential for the Trump administration to favor protectionist trade policy. This posed a threat to stability within the EMD asset class for which, from our perspective, investors were not being adequately compensated. Those concerns have been validated as of late, and our preference for domestic focused fixed income has been rewarded so far this year. Bank loans, our preferred lower-quality asset class, have returned 2.0% this year through June 22, while high yield returned 0.7% over the same period. Meanwhile, EMD has returned -4.9%.*

1 IG SPREAD WIDENING HAS OUTPACED HIGH YIELD



Source: LPL Research, Bloomberg 06/25/18

Indexes: Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays U.S. Corporate High Yield Index.

Indexes are unmanaged and 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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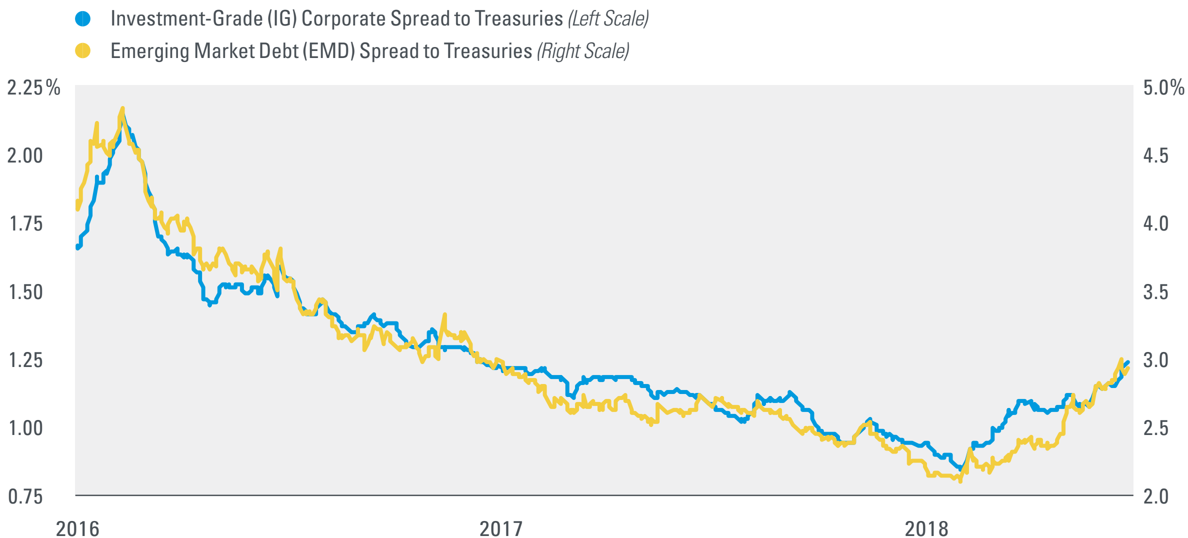
Similar to IG corporates, EMD generally has higher interest rate sensitivity than high yield, making it more susceptible to weakness in rising rate environments, and even more so if investors believe rates will continue to rise, leading to additional selling and spread pressure. Regardless of those other potential reasons, the spread widening patterns in EMD and IG corporates have been very similar [Figure 2], potentially indicating that they are both facing headwinds related to trade concerns.

CONCLUSION

Despite the recent escalation in trade tensions, we believe a full-scale trade war will be averted and negotiation still remains the likely path forward. Additionally, the tariffs currently in place remain manageable, and there's plenty of time before any new tariffs under discussion would kick in. However, markets have grown concerned, evidenced by recent equity market weakness and spread-widening within certain segments of the fixed income market; with segments and sectors potentially more exposed being under greater pressure in recent months. ■

2 IG CORPORATE SPREAD WIDENING HAS BEEN SIMILAR TO EMD RECENTLY



Source: LPL Research, Bloomberg 06/25/18

Indexes: Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays EM USD Aggregate Index.

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*Performance statistics reflect the total return of the S&P/LSTA U.S. Leveraged Loan 100 Index, the Bloomberg Barclays U.S. Corporate High Yield Index and the Bloomberg Barclays EM USD Aggregate Index.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

INDEX DESCRIPTIONS

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S Corporate High-Yield Bond Index is an unmanaged market value weighted index composed of fixed-rate, publicly issued, non-investment grade debt.

The Bloomberg Barclays Emerging Markets USD Aggregate Index is a flagship hard currency emerging market (EM) debt benchmark that includes fixed and floating-rate U.S. dollar–denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers. Country eligibility and classification as emerging markets is rules-based and reviewed annually using World Bank income group and International Monetary Fund (IMF) country classifications.

The S&P/LSTA (Loan Syndications and Trading Association) U.S. Leveraged Loan 100 Index measures the performance of 100 large loan facilities meeting specific inclusion criteria. The index is modified market value-weighted and is fully rebalanced semi-annually. In addition, the index is reviewed weekly to reflect pay-downs and ensure that it continually maintains 100 loan facilities.

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