LPL RESEARCH

BOND MARKET PERSPECTIVES

December 19 2017

NOTHING ADO ABOUT MUCH

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KEY TAKEAWAYS

As Congress moves toward passing tax reform, long-term Treasury yields have been stagnant, out of sync with equity markets that are moving higher on this progress.

Treasury futures markets are showing indecision and Treasury market volatility is near historically low levels.

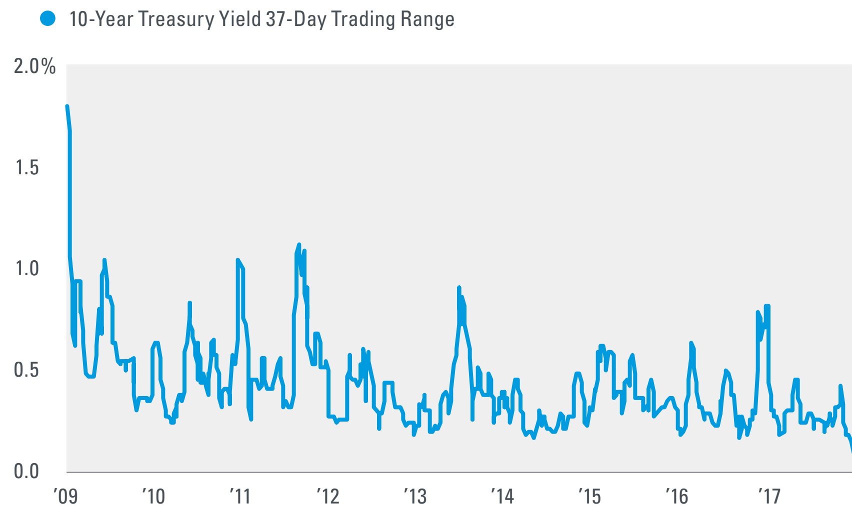
One segment of the market reacting to legislative progress is short-term yields, which have continued to move higher in response to more aggressive rate hike expectations for 2018.

In anticipation of a large tax reform deal that has powered equity markets higher, the Treasury market has been oddly quiet. Tax cuts for both corporations and individuals have many investors anticipating a pickup in economic growth and inflation. Yet longer-term Treasury yields, largely reflective of growth and inflation expectations, have barely budged in over a month and a half. Most of the action in interest rates has been concentrated in short-term yields, which have steadily marched higher since early September.

TRADING RANGE

The complacency in longer-term yields has been historic. Over the 37 trading days from October 27 through December 18, 2017, the 10-year Treasury yield has closed in a range of just 9.6 basis points (0.096%). This is the tightest trading range of that length since February 1974 [Figure 1]. Other volatility measures corroborate this. The Merrill Lynch Option Volatility Estimate (MOVE) Index, a measure of Treasury market volatility and the fixed income market's equivalent of the equity market's CBOE Volatility (VIX) Index, is just above

1 RECENT TRADING RANGE OF THE 10-YEAR TREASURY YIELD IS TIGHTEST IN OVER 40 YEARS



Source: LPL Research, Bloomberg 12/18/17

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all-time lows. The top 10 lowest readings in the history of the indicator all occurred during either November or December of this year.

Futures markets are also showing very little certainty. Net short positions in the futures market for the 10-year Treasury reached extremes in early 2017. This can be a good contrarian indicator, as generally when sentiment is that negative, positive news (for Treasuries) can lead to demand outweighing supply, which can drive Treasury yields lower. As we expected, this led to a decrease in yields. The market then moved to an extreme net long futures position near midyear. We warned this could lead to an increase in yields, which is how that scenario also played out. That same market is now virtually flat, evenly split between longs and shorts in the futures market. This is yet another sign of a market in search of direction.

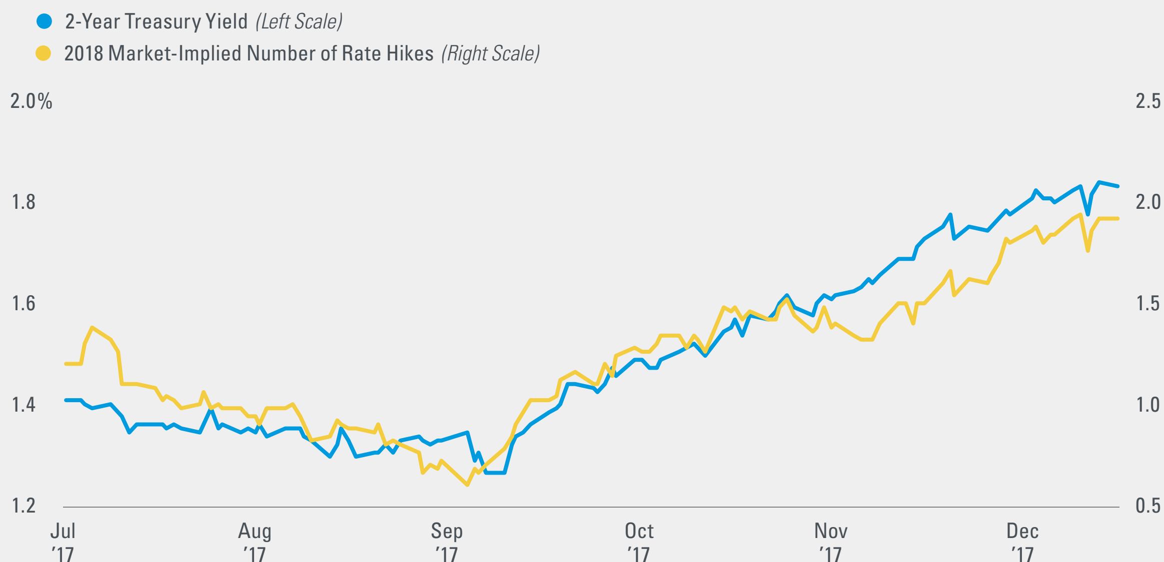
THE FED'S INFLUENCE

One area where there has been action recently is in shorter-term yields. Although longer-term yields have been stagnant, the 2-year Treasury yield has marched higher by 57 basis points (0.57%) since September 8, 2017. Although that rise over a 70-day trading period is not that historically impressive on an absolute basis, it is impressive on a percentage basis. On September 8, 2017, the 2-year Treasury yield was just 1.26%, so the 0.57% increase from there represents a 45% increase in yield. Although this has happened before, it has only occurred in roughly 2% of all 70 trading day rolling periods going back to 1977.

This increase in shorter-term yields has been driven by increasing expectations for future Federal Reserve (Fed) interest rate hikes [Figure 2].

Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors. A futures contract is a legal agreement, generally made on the trading floor of a futures exchange, to buy or sell a particular commodity or financial instrument at a predetermined price at a specified time in the future.

2 RISING RATE HIKE EXPECTATIONS HAVE LED TO SHARP MOVE HIGHER IN 2-YEAR TREASURY YIELD



Source: LPL Research, Bloomberg 12/18/17

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Market-implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Fed Funds Futures are a product offered by the Chicago Board of Trade which allow investors to speculate on what the Federal Reserve will do with interest rates. Rate hike expectations may not develop as predicted.

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> Fixed income markets are still digesting the long-term growth and inflation implications of tax reform, evidenced by sideways long-term yields, but are aggressively pricing in faster rate hikes as the cycle continues.

Although the Fed just raised rates in December, markets are anticipating a more aggressive Fed in 2018 than just months ago. Improving economic data is helping that push, with tax reform clearly being a stimulative measure that could make the Fed more aggressive with rate hikes in 2018, in an effort to stay ahead of a potential pickup in inflation beyond their 2% target. Fixed income markets are still digesting the long-term growth and inflation implications of tax reform, evidenced by sideways long-term yields, but are aggressively pricing in faster rate hikes as the cycle continues.

FLATTENING CURVE

The net result of rising short-term yields and stagnant long-term yields has been a flattening yield curve. One factor that may be helping flatten the yield curve is global demand. Interest in high-quality developed market sovereign debt remains strong, and the United States boasts longer-term yields far above those of Germany, Japan, and almost all other highly rated developed nations. As we have seen throughout 2017, a material rise in Treasury yields has inexorably been met with a pickup in foreign demand, limiting further upward moves in long-term rates, and thus leading to a flatter curve. For more information on the flattening yield curve and what it may mean, please see our recent *Bond Market Perspectives*, "Further Flattening."

CONCLUSION

Despite the excitement in equity markets surrounding the tax plan and potential resulting economic growth boost, Treasury markets remain seemingly unconvinced. The tight trading range in long-term Treasury yields, the indecision in the Treasury futures market, and low trading volatility all point to a market searching for direction. As tax plan details are cemented and finally enacted, we may get a better sense of Treasury yields' direction. As outlined in our *Outlook 2018* publication, we expect yields to move higher throughout 2018, with more volatility than current levels, as growth and inflation notch higher and central bank support gradually wanes globally. However, we may have to wait until 2018 for rates to wake up from their late year lull. ■

Please note, this will be our last *Bond Market Perspectives* of the year, as we will take next week off to be with our families. See you in 2018!

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 three-month, two-year, five-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.

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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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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 involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

INDEX DESCRIPTIONS

The Bloomberg Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.

The VIX is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive, it does measure the current degree of fear present in the stock market.

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