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MIDYEAR OUTLOOK 2017

CAREFUL NOT TO OVERLOAD

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KEY TAKEAWAYS

We expect the 10-year Treasury yield to end 2017 in the 2.25–2.75% range, with the potential for a move toward 3.0% should anticipated policy support lead to a meaningful rise in economic activity.

Higher rates of economic growth and inflation, along with the potential for an additional Fed rate hike this year, may put bond prices under pressure moving forward.

Fixed income plays a vital role in a well-diversified portfolio, providing income and liquidity during times of market stress.

FOR NOW, LITTLE STRESS IN FIXED INCOME

Historically, the bond market has been a pretty good indicator of increased potential for economic and geopolitical risk and thus far, we see little stress evident in the fixed income markets. Of course, year to date, shorter-dated U.S. Treasury prices have weakened as the front end of the yield curve adjusted to the Federal Reserve's (Fed) gradual approach to tightening. For longer-dated Treasuries, following a sharp move lower immediately after the election, periodic increases in demand due to geopolitical threats, European elections, mild inflation, and attractive valuations relative to other sovereigns, have kept prices relatively stable. Moreover, the spread between high-yield and investment-grade corporate bond yields relative to Treasuries, and the cost to insure against potential corporate defaults, have failed to signal potential looming threats [Figure 1].

Nonetheless, higher rates of economic growth and inflation, along with the potential for one additional Fed rate hike in 2017 (making three for the year), may put bond prices under pressure moving forward. As such, we continue to favor fixed income positioning with neutral to below-benchmark interest rate sensitivity. Despite our expectation for stability in credit markets, outperformance of the high-yield sector relative to high-quality fixed income has led to tight spreads relative to long-term averages, limiting return potential and warranting caution for investors. With little room for capital appreciation, yield is poised to be the dominant driver of return for investors.

Please see our *Midyear Outlook 2017: A Shift In Market Control* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.

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U.S. RATE EXPECTATIONS

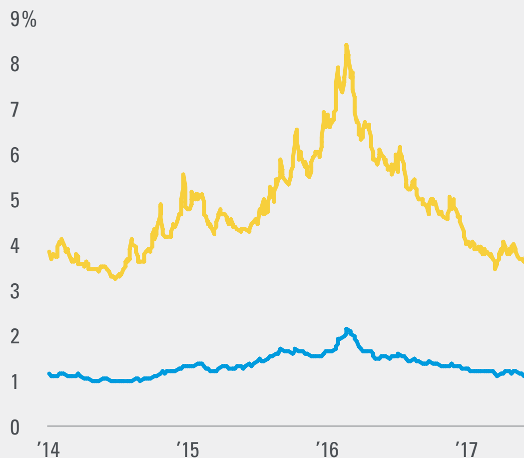
Our view on interest rates remains unchanged from the first half of 2017. We continue to believe that the combination of government policy, central bank policy, and steady economic growth has the potential to push the 10-year Treasury yield higher, and that our year-end target of 2.25%–2.75% remains reasonable. Our bias is toward the upper end of the range, and we could see the 10-year Treasury yield rise as high as 3%, should Congress make meaningful progress toward enacting fiscal stimulus.* At that level, however, international demand may once again return as valuations would become very attractive to other sovereigns, most notably for Japanese Government Bonds and German Bunds [Figure 2].

RISKS TO OUR RATE CALL

Risks to our rate call include delays in pro-growth policies, geopolitical risk, and potentially mixed messages from economic data. As demonstrated earlier in the year, delays in pro-growth policy could drag down longer-term yields and support U.S. Treasuries. Geopolitical tensions could flare up any time (e.g., Syria, North Korea) and drive demand for Treasuries. Finally, the disconnect between "soft data" (confidence) and "hard data" (manufacturing and employment) could persist, leaving rates lower longer than we would otherwise expect.

*Treasury Forecast: 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.

1 CREDIT SPREADS ARE SIGNALING CONFIDENCE IN CREDIT MARKETS

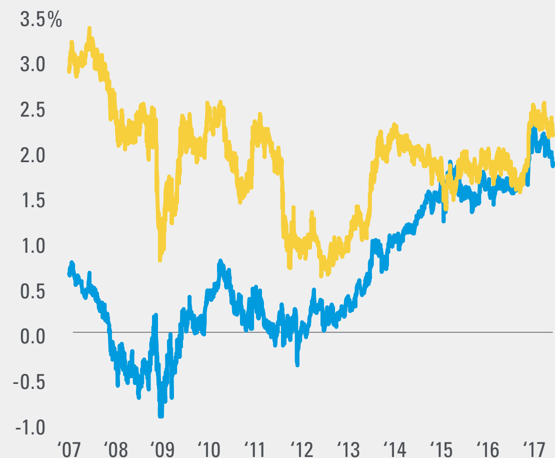


Source: LPL Research, Bloomberg 05/19/17

Option adjusted spread for Bloomberg Barclays U.S. Corporate Bond Index. Option adjusted spread for Bloomberg Barclays U.S. Corporate High Yield Bond Index.

Yield of each index over comparable maturity Treasuries.

2 TREASURIES SHOWING POWER RELATIVE TO GERMAN BUND AND JGB



Source: LPL Research, Bloomberg 05/19/17

Investing in foreign and emerging markets 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.

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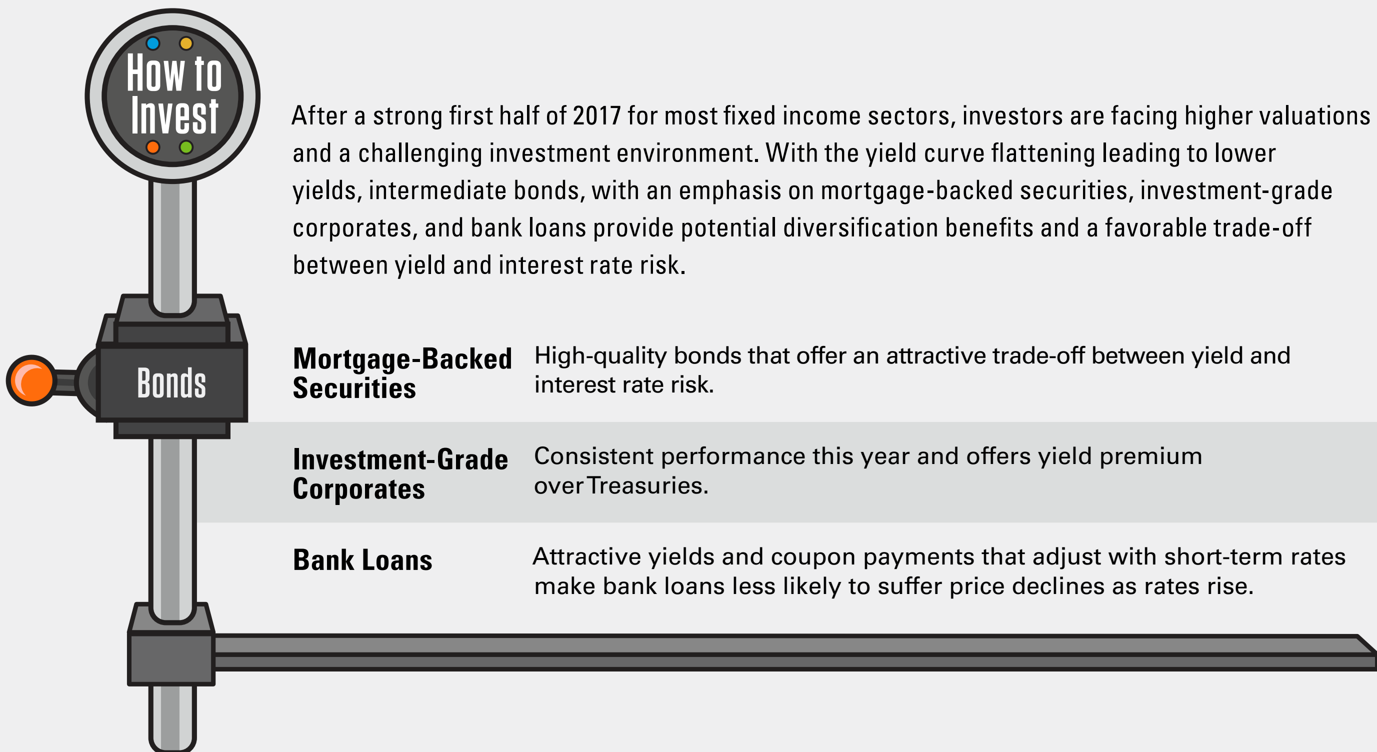
CONCLUSION

Despite our expectation for muted bond market performance in the second half of 2017, we continue to believe fixed income plays a vital role in a well-diversified portfolio, providing income and liquidity during times of market stress. High-quality bonds may serve as an important diversifier, also helping to manage portfolio risk. Although the absolute return may be minimal, high-quality fixed income's value as a risk mitigation tool should be emphasized in the fixed income portion of one's diversified investment portfolio. ■



After a strong first half of 2017 for most fixed income sectors, investors are facing higher valuations and a challenging investment environment. With the yield curve flattening leading to lower yields, intermediate bonds, with an emphasis on mortgage-backed securities, investment-grade corporates, and bank loans provide potential diversification benefits and a favorable trade-off between yield and interest rate risk.

Mortgage-Backed Securities	High-quality bonds that offer an attractive trade-off between yield and interest rate risk.
Investment-Grade Corporates	Consistent performance this year and offers yield premium over Treasuries.
Bank Loans	Attractive yields and coupon payments that adjust with short-term rates make bank loans less likely to suffer price declines as rates rise.

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.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

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.

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

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. These risks are often heightened for investments in emerging markets.

The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds. The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. The range of this spread is an indicator of the market's belief in the stability of the economy.

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.

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

INDEX DEFINITIONS

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.

The Bloomberg Barclays U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes U.S. dollar-denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

The Bloomberg Barclays U.S. Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

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).

This research material has been prepared by LPL Financial LLC.

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