LPL RESEARCH
BOND MARKET PERSPECTIVES

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A TALE OF THREE MARKETS

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KEY TAKEAWAYS

Fixed income investors experienced three different market environments during the third quarter: relative calm, several flight-to-safety events, and a resumption of risk taking.

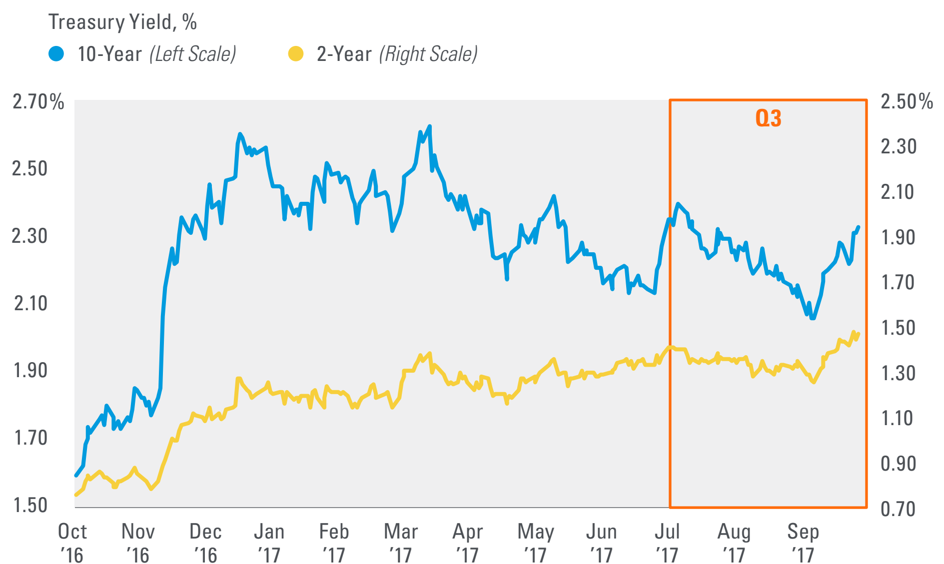
Though interest rates were volatile during the third quarter, we continue to believe steady growth combined with central bank policies may mean the 10-year Treasury yield ends the year in a range of 2.25% to 2.75%, with the potential for as high as 3% if meaningful fiscal stimulus is enacted.

The third quarter of 2017 was in many ways a tale of three markets for fixed income investors. When comparing the 10-year yield at the beginning of the quarter (2.35% on July 3, 2017) to the end of the quarter (2.33% on September 29, 2017), it doesn't look like much changed. However, this couldn't be further from the truth, as Figure 1 shows. Yields were moving higher when the third quarter began, as markets digested better than expected economic data and a hawkish tone from European Central Bank (ECB) President Mario Draghi. The 10-year yield was basically flat for July, before falling in August and recovering in September.

A SUMMER OF RISK

July ended up being a relatively quiet month for fixed income. Yields initially dropped as the ECB pulled back from President Draghi's hawkish comments and the minutes of the Federal Reserve's (Fed) June policy meeting showed a robust discussion on the potential for continued below-target inflation.

1 AFTER DECLINING AND REBOUNDING, TREASURY YIELDS ENDED THE QUARTER FLAT



Source: LPL Research, FactSet 10/02/17

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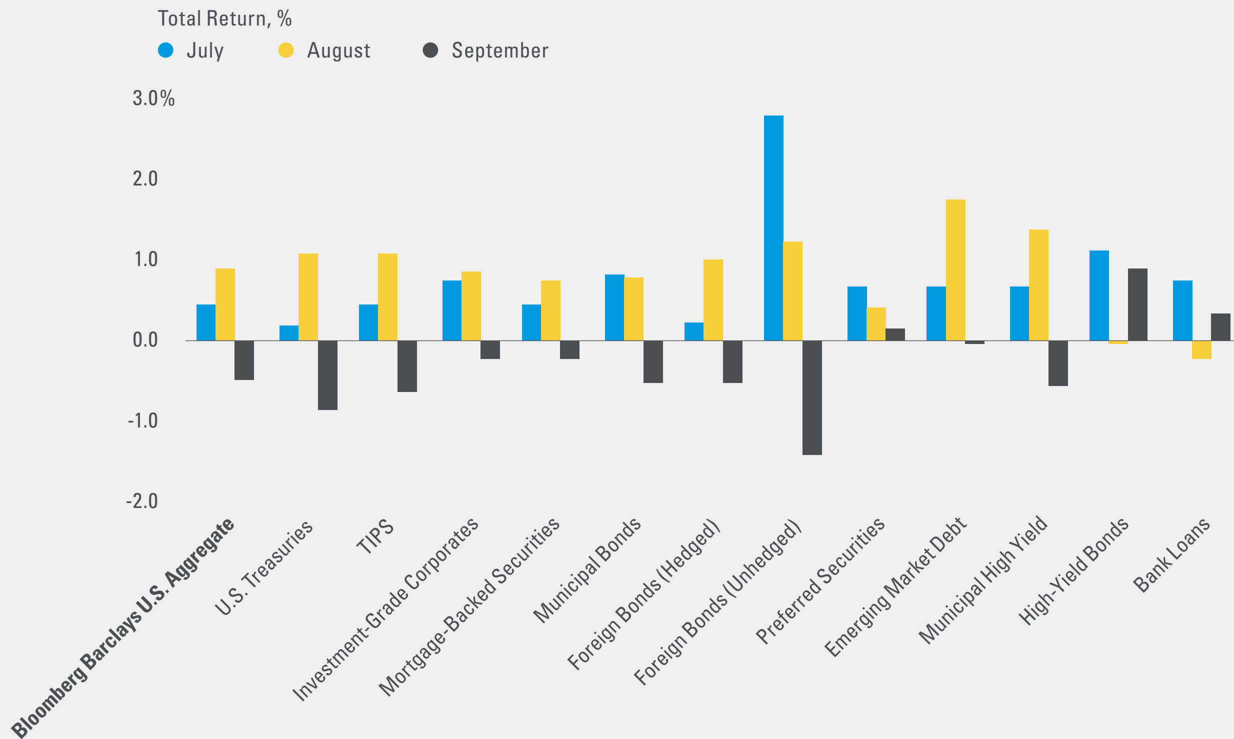
However, yields did recover slightly toward month end, leaving both 10- and 2-year Treasury yields about 0.05% lower on the month. Figure 2 shows that economically sensitive sectors of the fixed income market, such as high-yield bonds and bank loans, performed well in July, but some high-quality sectors, including corporate and municipal bonds, also saw strength. However, unhedged foreign bonds saw the strongest gains as the dollar saw significant weakness.

In early August, a positive earnings season began to fade, and political, geopolitical, and weather risks started to come into play. On the political front, fixed income markets started to reflect concerns about a potential debt ceiling debate. Investors demanded higher yields for a three-month Treasury auction in late July and a one-month offering in early September, both of which would have matured after the Treasury's debt ceiling deadline in late September. This increased yield indicated that market participants were concerned that the Fed may not have been able to make timely principal payments upon maturity.

On the geopolitical front, North Korean missile launches (including two that travelled over Japan) and the test detonation of what was assumed to

2 **FIXED INCOME INVESTORS EXPERIENCED THREE DIFFERENT TYPES OF MARKETS IN THE THIRD QUARTER**



Source: LPL Research, FactSet 10/02/17

TIPS – Treasury Inflation Protected Securities

Indexes referenced are: BofA Merrill Lynch Hybrid Preferred Securities Index, Bloomberg Barclays High Yield Municipal Bond Index, JPMorgan EMBI Global Index, Bloomberg Barclays US High Yield Index, Citigroup World Government Bond Index Unhedged, Bloomberg Barclays Municipal Bond Index, Bloomberg Barclays US Aggregate Credit Index, Bloomberg Barclays US Treasury Inflation Protected Notes Index, Bloomberg Barclays US Aggregate Bond Index, S&P/LSTA Leveraged Loan Index, Bloomberg Barclays US Aggregate Government Treasury Index, Bloomberg Barclays US Aggregate Securitized MBS, Citigroup World Government Bond Index Hedged.

All indexes are an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

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be a hydrogen bomb in late September, as well as a terrorist attack in Spain, made headlines. But as August ended, markets were turning their attention toward the potential devastation of three major hurricanes: Harvey, which hit the Texas gulf coast; Irma, which struck Florida; and Maria, which devastated Puerto Rico and many other islands.

These events caused several flight-to-safety rallies during August, leading to underperformance in credit-sensitive areas of the market such as high-yield bonds and bank loans, and better performance for safe-haven assets such as Treasuries and Treasury Inflation-Protected Securities (TIPS).* High-yield municipal bonds benefited from their longer duration, while duration (interest rate sensitivity) and richening valuations also helped emerging market debt perform well.

SEPTEMBER RELIEF

The elevated risks of August began to fade in early September. The 10-year Treasury yield hit its year-to-date low of 2.05% on September 7, and it has since moved significantly higher, leading to headwinds for high-quality fixed income. President Trump's unexpected debt ceiling deal with Democrats was approved by the Senate on the same day, and kicked the can on that potentially market-moving issue until December. North Korea tensions have continued to simmer, though the level of rhetoric has been toned down somewhat since the latest round sanctions passed the United Nations in mid-September. And the damage from Hurricane Irma, while unbelievably devastating, was less severe than anticipated. The fading of these risks (even if potentially only temporary), as well as another string of steady economic data, has helped improve the mood of markets and helped push yields higher.

One additional factor that we can't leave out for September has been the Fed. The central bank's announcement of plans to begin its previously detailed balance sheet normalization program in October, as well as hawkish comments from Fed Chair Janet Yellen indicating that interest rate hikes may be appropriate even in the face of below-target inflation, have also been a factor in the bounce in rates we saw in September.

Rising rates during September led to weakness in longer-duration sectors, and this combined with a Fed-driven stronger dollar led to weakness in unhedged foreign bonds in September. The increase in risk appetite, however, benefited high-yield bonds and bank loans.

CONCLUSION

The third quarter of 2017 in many ways exhibited characteristics of three different types of markets. Though rates fell slightly in July, volatility was relatively light. Rates fell further in August as markets experienced several flight-to-safety events, while many of the risks that markets were concerned with in August faded and rates moved higher in September, with an assist from the Fed.

Central bank policy may become more impactful in the months ahead. Though the Fed's balance sheet normalization program may likely have little impact in the fourth quarter, markets are continuing to price in a solid chance of a Fed rate hike in December (fed funds futures currently show a 78% chance of a hike), and the ECB is widely expected to announce an adjustment to its quantitative easing program in late October, which could put upward pressure on both foreign and domestic rates. Although the recent rise in rates has been significant, we believe it can hold and that rates could have even more room to move higher to end the year in a range between 2.25% and 2.75%, with the potential for as high as 3% if meaningful fiscal stimulus is enacted, as outlined in our *Midyear Outlook*.** ■

*U.S. Treasuries and TIPS may be considered "safe-haven" investments but do carry some degree of risk including interest rate, credit, and market risk. They 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.

**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.

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.

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.

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.

High-yield/junk bonds (grade BB or below) are not investment-grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

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.

Preferred securities investing involves risk, which may include loss of principal.

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.

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), while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of are that the CPI might not accurately match the general inflation rate; therefore, the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

INDEX DESCRIPTIONS

The Bloomberg Barclays High Yield Bond Index covers the universe of publicly issued debt obligations rated below investment grade. Bonds must be rated below investment grade or high yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, and Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be U.S. dollar denominated and nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

The Bloomberg Barclays U.S. High Yield Loan Index tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the U.S. High-Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.

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).

The 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. 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.

The Bloomberg Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed, pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflation-protected securities issued by the U.S. Treasury.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

The BofA Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research.

The Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market.

The Bloomberg Barclays High Yield Municipal Bond Index measures the performance of the high-yield municipal bond market. To be included in the index, bonds must be rated non-investment-grade (Ba1/BB- or lower) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be non-investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

The Credit Suisse Leveraged Loan Index tracks the investable market of the U.S. dollar denominated leveraged loan market. It consists of issues rated "5B" or lower, meaning that the highest rated issues included in this index are Moody's/S&P ratings of Baa1/BB+ or Ba1/BBB+. All loans are funded term loans with a tenor of at least one year and are made by issuers domiciled in developed countries.

The World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indexes are available in any combination of currency, maturity, or rating.

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