LPL RESEARCH

BOND MARKET PERSPECTIVES

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SAVED BY THE BELL

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KEY TAKEAWAYS

High-quality fixed income was on pace for another negative month late in October, but global events caused a last minute rally.

Jerome Powell's rise as the favorite for the Fed chair role sent yields lower, with expectations for slower future rate hikes by the Fed.

Prospects for central bank dovishness globally were increased in late October by statements from the ECB and the BOE about future policy.

After declining materially during the middle part of October, the Bloomberg Barclays U.S. Aggregate Bond Index rallied during the last three trading days of the month, helping the broad bond index eke out a slight gain. High-quality fixed income was under pressure for most of October, as progress was made toward tax reform and economic data continued to improve, pressing yields modestly higher. By the end of the month, dovish central bank action from the European Central Bank (ECB) and the Bank of England (BOE), in addition to the anticipated nomination of Jerome Powell to the Federal Reserve (Fed) chair role, were tailwinds for high-quality fixed income.

GLOBAL DOVISHNESS

Moves by the ECB and the BOE aided in pushing rates lower globally, helping to press the U.S. Aggregate above flat for the month of October. On the surface, the actions by both central banks appear to be hawkish. The ECB announced that it would reduce its current pace of bond purchases and the BOE hiked short-term interest rates. Looking a little deeper, however, both central banks struck a dovish tone with markets.

The ECB announced that it would cut bond purchases from 60 billion euros per month to 30 billion euros for the first nine months of 2018, in line with market expectations. What was more dovish than forecast, however, were the details and the post-meeting remarks, in which ECB President Mario Draghi signaled to markets that bond purchases (and thus monetary stimulus) was likely to continue after the nine-month period was up. The ECB also reserved the right to increase these purchases if conditions warrant. The dovish bias of these comments was a tailwind for fixed income, sending yields falling in Europe.

The BOE also pulled off a hawkish action with dovish undertones in late October. Facing rising inflation due to a weak pound but tepid growth, the BOE felt obligated to hike its benchmark short-term interest rate for the first time since 2007. While the hike in a vacuum may have sent rates higher, the dovish commentary that accompanied it actually sent rates lower. The BOE essentially said that it may hike rates just two more times over the next three years, a slower pace than was anticipated by markets. So despite hiking interest rates, U.K. government yields fell across the entire yield curve: a "dovish hike," to be sure.

Hawks versus Doves: The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

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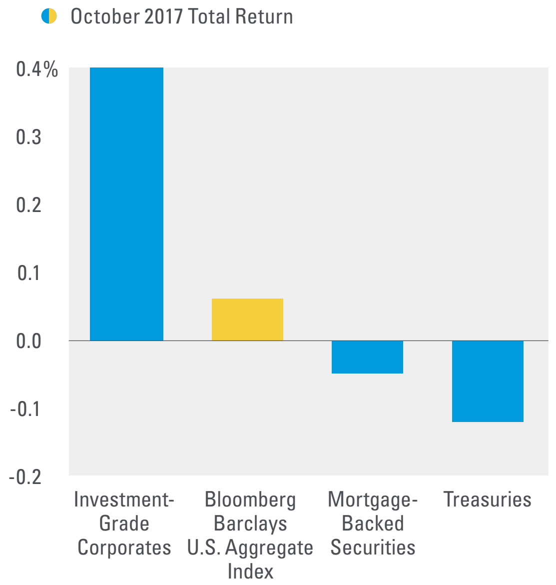
After President Trump considered noted hawks Kevin Warsh and John Taylor to lead the Fed, Jerome Powell's ascension was a calming tailwind for fixed income markets, and also contributed to the broad market's rally heading into month end. Powell is considered a policy dove, especially relative to other frontrunners (excluding current Fed Chair Janet Yellen), and can be seen as a symbol of continuity for monetary policy domestically. Chances of a December rate hike continued to notch up throughout October. However, expectations for rate hikes in 2018 and 2019 gradually fell as Powell's chances for selection increased [Figure 1].

CORPORATE CATALYST

The U.S. Aggregate's barely positive return was mainly driven by investment-grade corporate bonds, as the other two major sectors in the index, Treasuries and mortgage-backed securities (MBS), were negative for the month [Figure 2]. Most of investment-grade corporates' return

2 INVESTMENT-GRADE CORPORATES WERE DOMINANT POSITIVE DRIVER IN OCTOBER

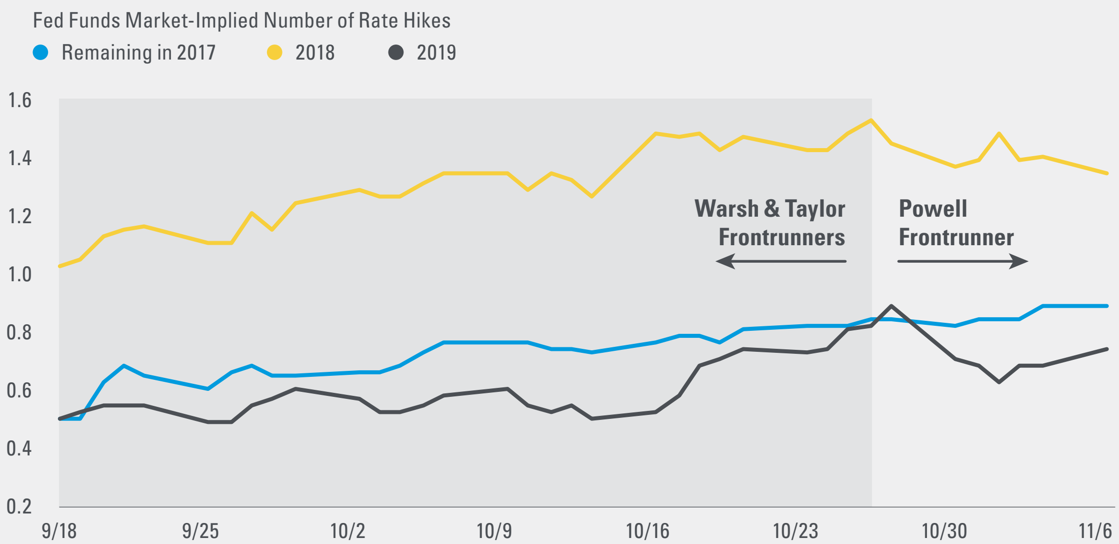


Source: LPL Research, Bloomberg. 11/06/17

Indexes referenced: Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays U.S. Aggregate Index, Bloomberg Barclays U.S. MBS Index, and Bloomberg Barclays U.S. Treasury 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.

1 FRONTRUNNER FOR FED CHAIR ROLE IMPACTED RATE HIKE EXPECTATIONS DURING OCTOBER



Source: LPL Research, Bloomberg 11/06/17

Market-implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate hike expectations may not develop as predicted.

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for the month was driven by coupon (yield); however, there was some positive price return as well, as corporate bond valuations continued to richen with rising equity markets and strong economic data. The ECB's dovish tilt may have benefited corporates as well; a continuation of the ECB's bond buying program may be a tailwind, not only by keeping European yields low relative to U.S. yields, but also because investors may be "crowded out" of the European market, creating more demand for U.S. investment-grade corporates, all else equal.

CONCLUSION

On October 26, the U.S. Aggregate was down 0.4% month to date and appeared to be on course for another month of losses for the broad high-quality bond market. The last three trading days of the month were full of market-moving events, however, as global forces combined to press the U.S. Aggregate higher to a small monthly gain. Despite tightening monetary policy accommodation somewhat, the ECB and BOE both left markets with a lingering dovish sentiment. Jerome Powell's nomination for the Fed chair role was also a dovish event for future monetary policy. These three events in three different central banks drove yields lower, and most high-quality bond prices higher, leading to a (barely) positive month for high-quality fixed income overall.

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.

A mortgage-backed security (MBS) is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. Payments are typically made monthly over the lifetime of the underlying loans.

INDEX DEFINITIONS

The Bloomerg 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 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 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. Bloomberg Barclay's U.S. Treasury Index includes public debt of the U.S. Treasury with a remaining maturity of one year or more.

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).

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