LPL RESEARCH

BOND MARKET PERSPECTIVES

2018 FIXED INCOME OUTLOOK

EXPECT FLAT TO LOW RETURNS

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KEY TAKEAWAYS

High-quality fixed income may be under pressure in 2018, as rates slowly move higher due to increased growth and inflation levels, in addition to continued rate hikes from the Fed.

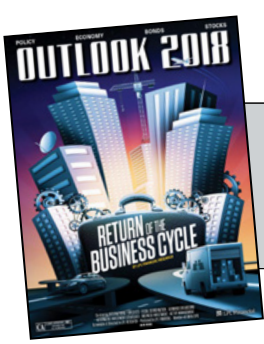
The waning of central bank support will also be a key theme in 2018 as the Fed has already started to normalize its balance sheet, with the ECB likely to follow suit in late 2018.

Given our outlook for the economy, Federal Reserve (Fed) policy, and the potential for fiscal stimulus, we expect the fixed income market to be under pressure in the coming year. Moderate gross domestic product (GDP) growth and rising inflation may lead to gradually higher interest rates, limiting bond returns. Investors in global fixed income markets can no longer count on central banks to support the asset class. That said, bonds remain an important element of a well-balanced portfolio, serving to provide protection should we experience equity market pullbacks.

RISING INTEREST RATES, A FAMILIAR FOE

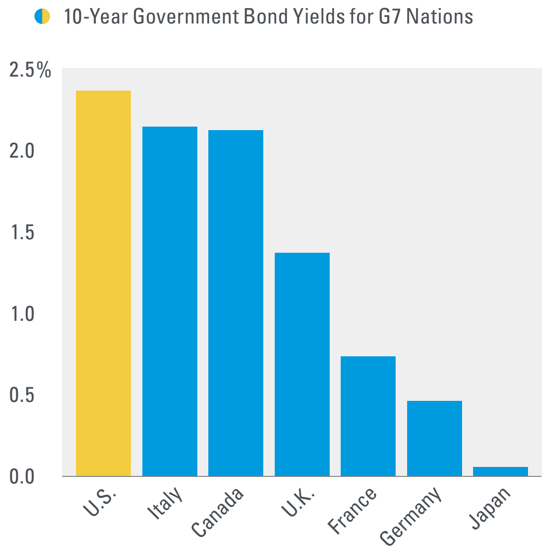
We expect high-quality fixed income to remain under moderate pressure in 2018, amid gradually increasing interest rates across the yield curve. Two to three additional Fed rate hikes will likely pressure short-term interest rates higher, while increasing levels of growth and inflation push long-term interest rates higher. Given the continued, albeit modest, pickup in growth and inflation, we would expect the 10-year Treasury yield to end 2018 in the 2.75–3.25% range.

The Fed's efforts to reduce its balance sheet will add to this dynamic during the coming year, but it may become a more important factor later in 2018, depending on whether other global central banks become more aggressive. U.S. Treasury yields are still higher than those in other developed nations, however, and any jump up in domestic interest rates may be met by increased demand from foreign investors, potentially limiting upward moves in Treasury yields [Figure 1].



Please see our *Outlook 2018: Return of the Business Cycle* 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.

1 **TREASURY YIELDS STILL HIGH FROM A GLOBAL PERSPECTIVE**



Source: LPL Research, Bloomberg 10/31/17

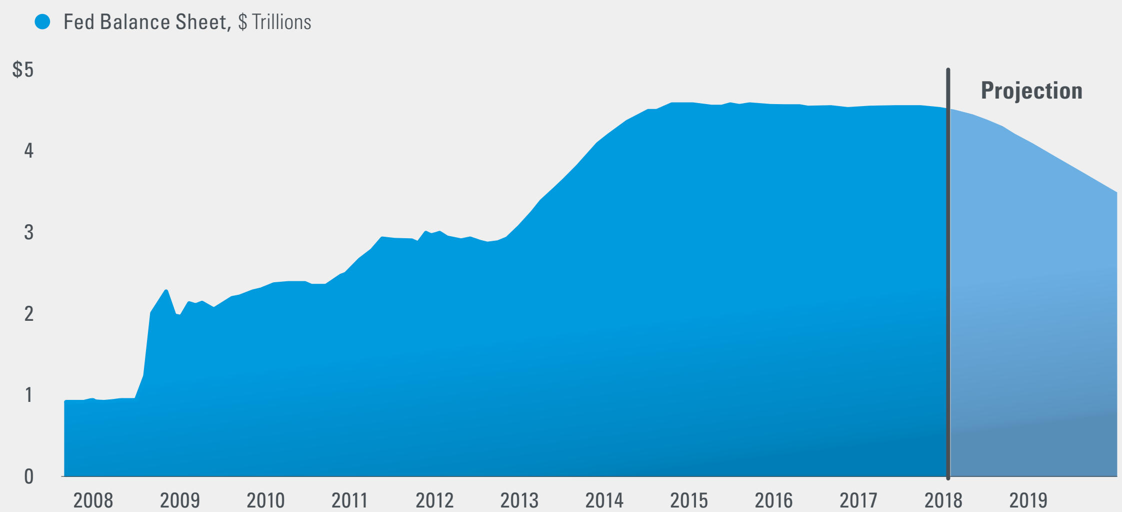
Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

LATEST MOVE BY THE FED: REDUCE THE BALANCE SHEET

In October 2017, the Fed began the process of gradually reducing its balance sheet by decreasing reinvestment of principal payments from maturing bonds. The Fed will allow $10 billion of maturing mortgage-backed securities (MBS) and Treasuries to roll off its balance sheet each month, which will increase by $10 billion every three months until reaching a maximum of $50 billion per month. The next scheduled increase will take place in January 2018 [Figure 2].

Using scenario analysis and our expectations for a gradual pickup in interest rates across the yield curve, we expect the total return for the Bloomberg Barclays U.S. Aggregate Bond Index to be within the range of flat to low-single-digits during 2018, slightly lower than our 2017 forecast of low- to mid-single-digits.

2 **FED ON THE PATH TO NORMALIZATION**



Source: LPL Research, Bloomberg 10/31/17

Within high-quality fixed income, we prefer an overweight to investment-grade corporate bonds, approximately benchmark weight to MBS, and an underweight to Treasuries. We continue to believe investment-grade corporate bonds can offer incremental value over Treasuries due to their yield premium over Treasuries and the positive backdrop for corporate America. While MBS offer above-Treasury yields and an attractive tradeoff between yield and interest rate sensitivity, the pace of the Fed's balance sheet reduction could put moderate pressure on MBS as the year progresses.

We maintain a preference for the intermediate portion of the yield curve, as we don't believe investors are adequately compensated for the additional interest rate risk of long-term bonds at current yield levels.

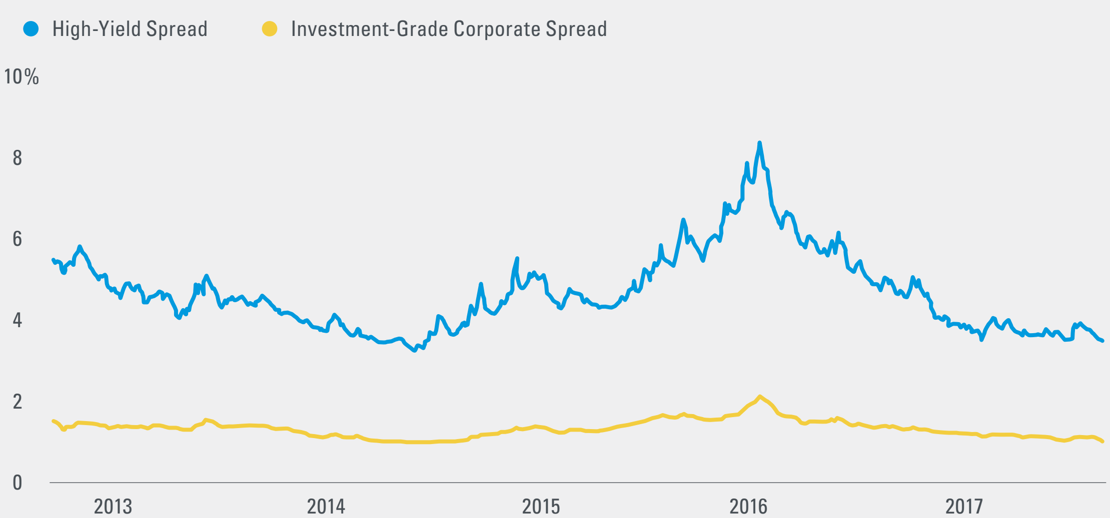
Lower-quality, more economically sensitive areas of fixed income may be poised for another decent year of returns as well. Amid continued equity market strength, our expectation for high yield is mid-single-digit returns. Though high-yield valuations are expensive relative to historical metrics, the combination of default levels, default forecasts, and loosening bank lending standards all support fundamentals and, we believe, justify current valuations. Because valuations are expensive, 2018 could potentially be a year in which yield drives the majority of return. Expensive valuations represent a two-sided coin: They do limit return potential, but they also indicate the high degree of confidence investors have in the ability of corporations to repay their debt obligations [Figure 3].

We remain constructive on bank loans, for their attractive yields, an elevated position in the corporate capital structure, and less interest rate sensitivity relative to high yield.

THE VALUE OF A GOOD SIDEKICK

Although high-quality fixed income may be under pressure next year, it remains a vital part of well-balanced, diversified portfolios. Investors should resist the temptation to move down the quality spectrum amid full valuations in asset classes like high yield.

3 **CREDIT MARKETS STILL SHOWING CONFIDENCE, LITTLE STRESS**



Source: LPL Research, Bloomberg 10/31/17

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.

Despite low-quality fixed income's outperformance over the last year, pullbacks in equity markets in recent years solidify our belief that high-quality fixed income is a valuable risk mitigation tool in balanced portfolios. Although lower-quality fixed income choices like high yield and bank loans may add yield and upside potential to fixed income allocations during times of economic and equity market strength, they do not provide the same protection as high-quality fixed income in down markets.

INTERNATIONAL BONDS WILL TRY TO REMAIN COOL UNDER PRESSURE

Foreign developed bonds could find themselves under pressure, like domestic high-quality fixed income. Relative to Treasuries, valuations are even more expensive in foreign government bonds, such as Germany and Japan. The European Central Bank (ECB) has announced plans to begin tapering bond purchases from a rate of 60 billion euros per month to 30 billion euros per month in January 2018, due to a desire to normalize monetary policy. Tapering purchases may put upward pressure on foreign interest rates, which, combined with rising levels of growth and inflation, may make for a tough road ahead for developed foreign bonds.

Emerging market debt (EMD) is also expensive on a valuation basis, with spreads over comparable Treasury bonds at multi-year lows. The continued global expansion should provide support for EMD, along with still accommodative global monetary policy. However, ECB tapering could create a headwind here as well. Historically, less accommodative policy has coincided with slowdowns in emerging market growth rates due to higher borrowing costs. In general, we prefer dollar-denominated EMD, as local currency EMD is more volatile due to the currency fluctuation for U.S.-based investors.

MUNI BONDS COULD BE A DOUBLE AGENT

For investors looking for tax-advantaged fixed income allocations, municipal bonds are still an important fixed income sector. The potential for tax cuts this month or in 2018 remains a slight negative, as a decline in tax rates makes the tax advantage of municipal bonds slightly less valuable, all else being equal. However, if tax reform limits certain types of issuance, it could be a tailwind for the municipal market.

The overhang of underfunded pension liabilities may drive credit risk up in certain states until they shore up their fiscal positions. The potential of an infrastructure plan, should it necessitate borrowing by states and municipalities, could also pressure the municipal market with excess supply in 2018. Puerto Rico remains a headline risk within the municipal space, but its challenges have been contained so far with limited spillover to the broader municipal market. ■

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.

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.

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

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 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.

INDEX DEFINITIONS

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.

The Bloomberg Barclays High-Yield Bond Index is an unmanaged index of corporate bonds rated below investment grade by Moody's, S&P or Fitch Investor Service. The index also includes bonds not rated by the ratings agencies.

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