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# WHAT HAS CHANGED FROM A YEAR AGO?

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## KEY TAKEAWAYS

Treasury yields are very similar to this time last year, despite their recent sharp rise.

We expect domestic growth and inflation expectations to push rates higher, though low foreign rates may continue to keep U.S. yields lower than they otherwise would be.

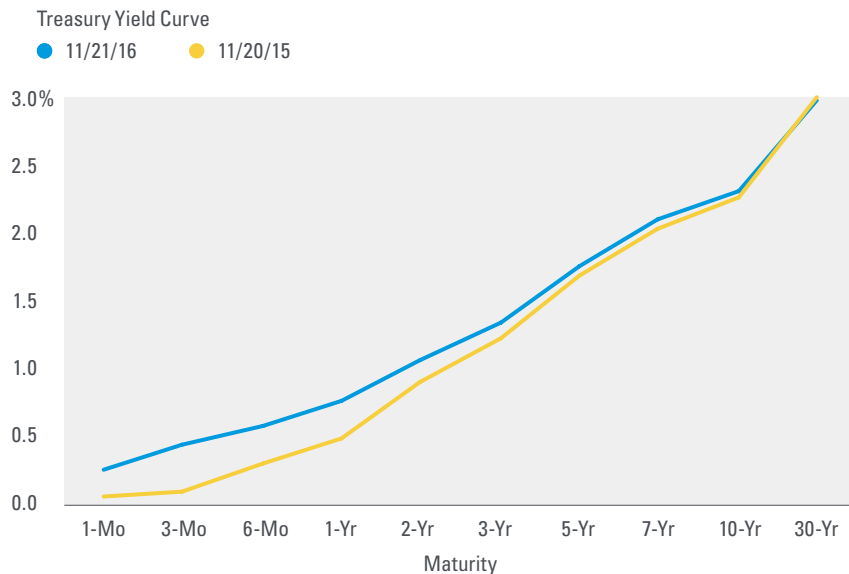
We continue to believe bonds' potential diversification benefits makes the asset class important from a portfolio context.

**November 2016 is shaping up to look a lot like November 2015 in the bond market, but it doesn't necessarily feel that way.**

During 2016, investors became more accustomed to rates falling than rising, though this wasn't the expectation as markets entered the 2015 holiday season. Looking back gives a sense of déjà vu in some respects. Following discussions throughout the year, markets were fixated on the possibility of a Federal Reserve (Fed) rate hike at the Federal Open Market Committee's (FOMC) meeting in December 2015, and intermediate- and long-term Treasuries were trading in a very similar range compared with today. In fact, the closing yield for the 10-year Treasury on November 14, 2015, was the same as it was on November 14, 2016: 2.26%. The 30-year Treasury yield is also near 2015 levels, closing at 3.03% on November 18, 2016, compared with 3.04% in November 2015.

**Figure 1** shows the Treasury yield curve now (late November 2016) and then (late November 2015). Some may be surprised to know that even following the recent steepening (where long-term interest rates have risen more than short-

### 1 DESPITE A VOLATILE YEAR, LONG-TERM RATES HAVEN'T CHANGED MUCH FROM A YEAR AGO



Source: LPL Research, FactSet 11/21/16

Performance is historical and no guarantee of future results.

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.

term rates, an indicator of improving economic expectations), the yield curve is actually flatter today than it was in 2015, as short-term rates are higher today on the prospect of another December Fed rate hike. Fed rate hike expectations drive short-term yields, whereas economic growth and inflation expectations are larger drivers of long-term yields.

## HOW DID WE GET HERE?

In November of 2015, market participants were broadly expecting higher rates in 2016, not the lower rates that we ended up seeing. Does this mean that rates could end up following the same pattern in 2017?

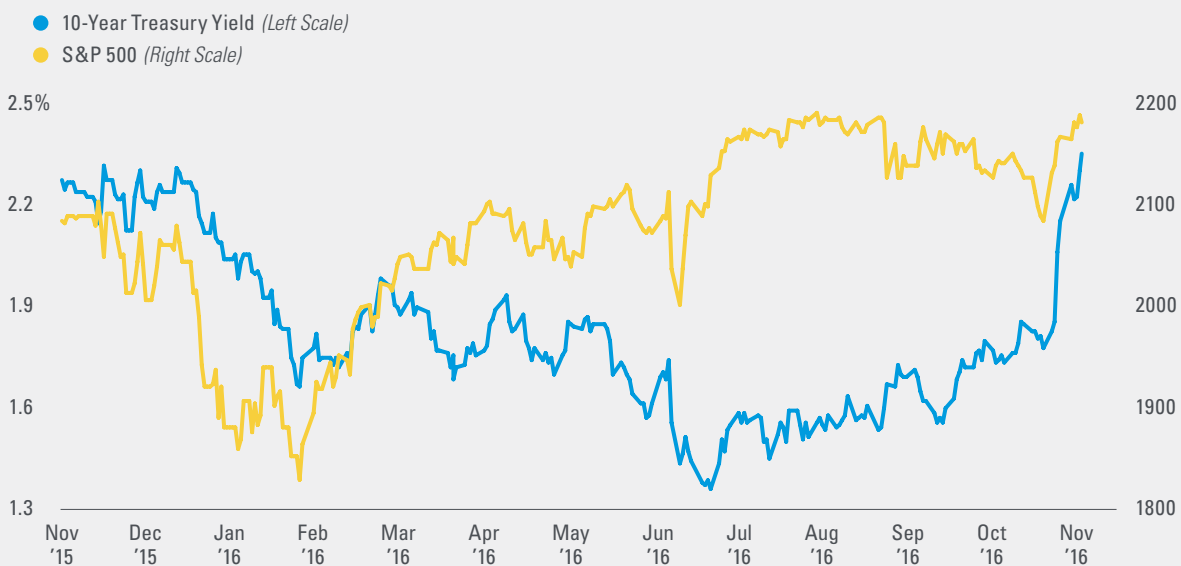
We don't believe the path of rates in 2017 is likely to look like 2016, and taking a look at the reasons behind the moves can offer some insight into why.

Shortly after the Fed's rate hike in December of 2015, the S&P 500 took a tumble, declining 14% peak-to-trough [Figure 2].

The fall in equity markets in early 2016 led investors toward the relative safety of Treasury bonds.\* Equity markets soon recovered however, helped by stabilization in oil prices, less volatility from China, and the Fed lowering their forecast for 2016 rate hikes from 4 to 2 in mid-March. Additionally, the Bank of Japan announced in January of 2016 that it was moving to a negative interest rate policy, and the European Central Bank (ECB) announced an expansion of its quantitative easing (QE) program a couple of months later in March 2016. Liquidity from global central banks, intended to help correct anemic growth rates in their local economies, have helped to keep a lid on U.S. yields over the past year, as the safety and yield advantage of U.S. Treasuries has caused an increase in foreign demand.

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

### 2 THE 10-YEAR TREASURY YIELD AND S&P 500 OVER PAST YEAR



Source: LPL Research, FactSet 11/21/16

Performance is historical and no guarantee of future results.

The S&P 500 is an unmanaged index which cannot be invested into directly.

## WILL WE REPEAT THE CYCLE?

The major difference between this year and last are expectations of future growth. Economic growth and inflation expectations have moved higher following the election, on expectations of increased fiscal spending and business-friendly policies. One of the easiest places to see this change is in implied inflation expectations, as measured by the difference between the 10-year Treasury and 10-year Treasury Inflation-Projected Securities (TIPS) yields (which have semiannual principal adjustments based on headline Consumer Price Index [CPI]). While only about 0.3% higher than this time last year, 0.23% of that change came within the last month-mid October 2016 through mid-November 2016, showing that markets are clearly giving President-elect Donald Trump the benefit of the doubt when it comes to growth. Recent Fed comments indicating that it may allow the economy to “run hot” in order to generate stronger inflation numbers may have also helped.

Actual reported growth and inflation numbers today are also slightly better than they were in November 2015. As [Figure 3](#) shows, the quarter-over-quarter change in real gross domestic

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product (GDP) for Q3 of 2016 was nearly a percent higher than reported in Q3 of 2015, though the year-over-year change in CPI is nearly the same. The yield curve is actually flatter as short-term rates have moved higher in anticipation of a Fed rate hike in December 2016.

A potential boost in fiscal spending and pro-business policies may help U.S. yields move higher in 2017, though the path of foreign economies, and especially their central banks, may again have an impact. Negative interest rate policies (NIRP) in Europe and Japan restrained U.S. yields over the past year, and have the potential to continue to exert downward pressure in the year ahead. Recent news of anti-European Union (EU) parties leading in Italian election polls have started to stoke fears of Italy leaving the EU and going back to the lira (the Italian currency previous to their adoption of the Euro). If this happens, it could force the ECB to further ease monetary policy, which would put additional downward pressure on foreign, and potentially U.S., yields.

### 3 GDP AND IMPLIED INFLATION EXPECTATIONS ARE HIGHER TODAY THAN THEY WERE IN NOVEMBER 2015

	11/21/16	11/20/15	Difference
Real GDP, Q3, Quarter-over-Quarter, %	2.90%	2.00%	0.90%
Consumer Price Index, October, Year-over-Year, %	1.64%	1.66%	-0.02%
10-Year Implied Breakeven Inflation	1.89%	1.60%	0.29%
Treasury Yield Curve Steepness, 10-Year Treasury Yield Minus 2-Year Treasury Yield	1.24%	1.35%	-0.11%

Source: LPL Research, St. Louis Federal Reserve, FactSet 11/21/16

GDP - Gross Domestic Product

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Breakeven inflation is a measured of the difference between Treasury yields and TIPS yields.

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.

## SPREADS ARE TIGHTER

One final difference between markets in late 2016 and late 2015 is the relative valuations of bond sectors. The valuations of some bond sectors are measured by how far their yield is from a comparable Treasury, a concept known as a spread. Spreads have broadly compressed since last year, meaning many areas of the bond market are more expensive relative to Treasuries than they were a year ago [Figure 4]. These moves may be somewhat justified by the improvement in economic growth forecasts and stabilization of oil prices, though if things don't materialize the way the market expects, it could lead to spread widening, where bond sectors would underperform Treasuries. However, we continue to believe that high-quality bonds, such as investment-grade corporates and mortgage-backed securities (MBS), will be able to continue to be important from a diversification perspective, and may benefit from a flight to low-risk bonds if economic reality doesn't match current forecasts and equity markets (and bond yields) move lower.

## CONCLUSION

Unlike the path of rates in 2016, we expect rates to have an upward bias in 2017, though at a measured pace. A boost in fiscal spending and pro-business policies may help U.S. yields move higher in 2017, though the path of developed foreign economies, and the central bank moves that go along with them, may continue to keep domestic rates lower than they otherwise would be. Many bond sectors are more expensive than they were a year ago. This could reflect improving economic prospects and stabilization in the price of oil, but may also mean that if forecasts aren't met, there could be more downside due to spreads widening. But even though bonds are more expensive and rates may rise over the course of the year, we continue to believe rates may rise slowly enough that interest income will help offset any principal losses, and that bond holdings offer potential portfolio diversification benefits, helping investors manage any volatility that may lie ahead. ■

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### MANY BOND MARKET SECTORS ARE MORE EXPENSIVE NOW THAN THEY WERE IN NOVEMBER 2015

	Spreads to Comparable Treasuries		
	11/21/16	11/20/15	Difference
Investment-Grade Corporate Bonds	1.14%	1.36%	-0.22%
Mortgage-Backed Securities	0.46%	0.49%	-0.03%
High-Yield Bonds	4.90%	6.31%	-1.41%
Emerging Markets Debt	3.81%	3.76%	0.05%

Source: LPL Research, Bloomberg 11/21/16

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

## 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.

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.

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

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.

Mortgage-backed securities are subject to credit, default risk, 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, 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.

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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