LPL RESEARCH
BOND MARKET PERSPECTIVES

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FIXED INCOME IN 2018: STILL UNDER PRESSURE

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KEY TAKEAWAYS

High-quality fixed income may remain under pressure in 2018.

The yield curve flattened considerably in 2017, which could continue in 2018, but may not be the ominous indicator it has been in previous cycles.

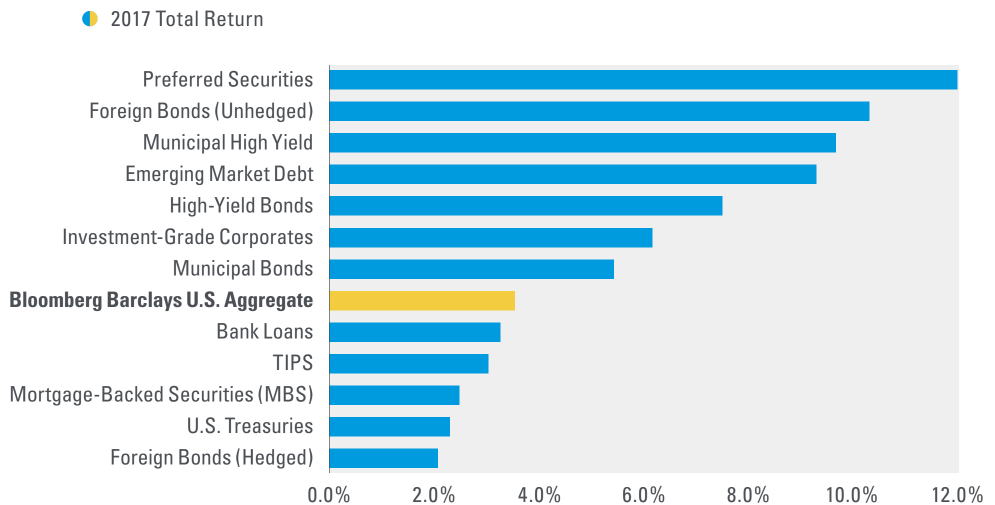
Though our return forecast for broad high-quality fixed income is muted, it remains an important component of diversified, balanced portfolios.

We look back at U.S. fixed income performance in 2017, while exploring what themes may persist in 2018. Today's *Bond Market Perspectives* will provide a high-level performance recap for 2017 that we hope will be helpful for year-end client conversations, in addition to a summary of our fixed income market views for 2018 following passage of the new tax law.

CLOSING THOUGHTS ON 2017

As we entered 2017, we expected that steady growth and up to three Federal Reserve (Fed) rate hikes would drive low- to mid-single-digit returns in the broad high-quality bond market. In the end, with three Fed rate hikes in 2017

1 CREDIT RISK WAS GENERALLY REWARDED IN 2017



Source: LPL Research, Bloomberg 01/08/18

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

TIPS – Treasury Inflation-Protected Securities

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

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and a total return of 3.7% for the Bloomberg Barclays U.S. Aggregate Bond Index, these forecasts aligned with reality. Our expectation that the 10-year Treasury yield would end 2017 in the 2.25%–2.75% range was also met, with the 10-year yield ending the year at 2.41%.

Our favored high-quality sectors were relative winners for the year as well. Corporate bonds, as measured by the Bloomberg Barclays Aggregate Credit Index, gained 6.2% for the year. Though mortgage-backed securities (MBS) saw comparatively smaller gains of 2.5% (as measured by the Bloomberg Barclays U.S. MBS Index), they did manage to outperform Treasuries which gained just 2.3% (per the Bloomberg Barclays U.S. Treasury Index). Economically sensitive, lower-quality segments of fixed income were winners broadly amid sharply higher equity markets during the year [Figure 1].

THE YEAR AHEAD

We expect high-quality fixed income to remain under moderate pressure in 2018, amid gradually increasing interest rates across the yield curve as the economy returns to the dynamics of a more normalized business cycle. The transition from an emphasis on monetary policy to fiscal policy will dominate the discussion, and is reflected throughout our views:

- Two to three additional Fed rate hikes may pressure short-term interest rates higher, while increasing levels of growth and inflation may push long-term interest rates higher. Given the continued, albeit modest, pickup in growth and inflation, we expect the 10-year Treasury to end 2018 in the 2.75–3.25% range.
- The Fed's efforts to reduce its balance sheet will add to this rising rates dynamic during 2018, but it may become a more important factor later in the year, depending on whether other global central banks become more aggressive in reducing their monetary stimulus as well. U.S. Treasury yields are still higher than those in other developed nations, so any jump in domestic interest rates may be met by increased demand from foreign investors, potentially limiting upward moves in Treasury yields.
- The new tax law adds to our concerns when considering the overall environment for bond investors, due to its potential to drive growth and inflation rates higher. The U.S. Treasury will need to increase issuance of debt in order to make up for the potential initial loss in tax revenues as the economy adjusts to the new dynamic. Though only time will tell relative to the anticipated supply-side benefits of the legislation, the immediate need to fund U.S. government activities and programs should result in further deficit spending, which typically results in bond investors demanding higher yields (by paying lower prices) for the extra risk of increased Treasury issuance. Additionally, while the limitation on deductibility of interest expense is a negative for corporate debt, some of that is offset by the positives of lower overall corporate tax rates, the full expensing of capital expenditures, and other provisions within the bill.

The yield curve flattening that was prevalent throughout 2017 may continue in 2018 [Figure 2]. This phenomenon usually worries investors, as historically an inverted yield curve has been an effective leading indicator of recessions. One contributor to this is the fact that longer-term yields in the U.S. are above those of Germany, Japan, and almost all other developed nations, and strong global demand may be restraining domestic rates. Additionally, global central bank action over the last decade could also be changing the efficacy of yield curve flattening as a recession predictor. Lower yield levels have forced investors to longer maturities, thus pushing those longer-term rates even lower, due to increased demand.

Similar to 2017, we favor intermediate-duration fixed income, as we don't believe long maturity can

offer enough compensation for the interest rate risk assumed. Another pattern that may continue in 2018 is lower-quality fixed income outperforming high quality. In line with our view of a strong year for equities, asset classes like high yield may enjoy another year of healthy returns. This return may be driven primarily by the yield component of returns, because high-yield spreads over comparable Treasuries are already at their tightest levels in over 10 years. Tight spreads indicate confidence in corporations' creditworthiness, but also limit future return potential.

CONCLUSION

Moving forward into 2018 and given our outlook for the economy, Fed policy, and fiscal stimulus, we expect the fixed income market to be under pressure given gradually higher interest rates, with a total return of flat to low-single-digits expected for the broad Barclays Aggregate. That said, we believe bonds remain an important element of a well-balanced, diversified portfolio, that could provide protection should we experience equity market pullbacks. ■

2 TREASURY YIELD CURVE FLATTENED MEANINGFULLY IN 2017

Source: LPL Research, Bloomberg 01/08/18

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. The most frequently reported yield curve compares the three-month, two-year, five-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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Please see our *Outlook 2018: Return of the Business Cycle* publication for additional descriptions and disclosures.

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.

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.

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. The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Mortgage-backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

INDEX DESCRIPTIONS

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 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 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 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. 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 Bloomberg 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 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. On August 24, 2016, Bloomberg acquired the Barclays fixed income benchmark indices from Barclays. Barclays and Bloomberg have agreed to co-brand the indices as the Bloomberg Barclays Indices for an initial term of five years.

The JPMorgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidity.

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