LPL RESEARCH

BOND MARKET PERSPECTIVES

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# TOUGH START FOR FIXED INCOME

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

## KEY TAKEAWAYS

The first quarter of 2018 was volatile, with rising interest rates triggering losses across most segments of fixed income.

Due to the large pickup in rates year to date, some of the pricing pain of bonds that we expected this year may be behind us.

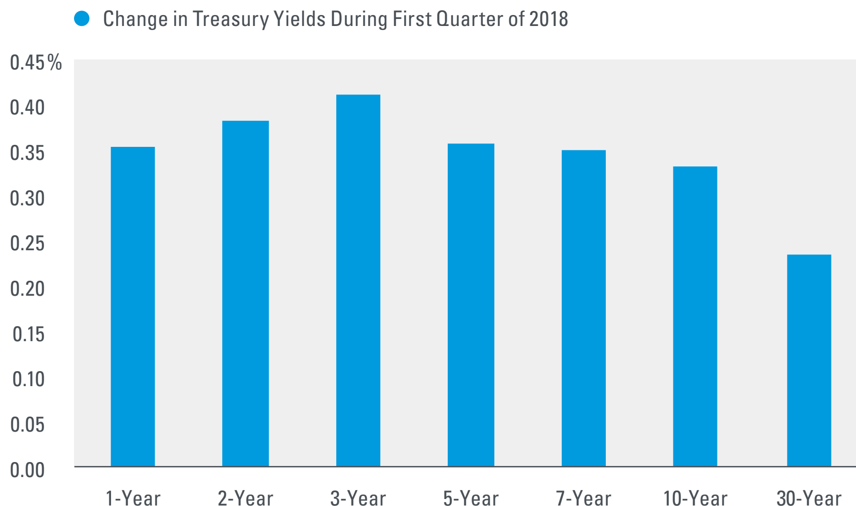
We continue to believe that the 10-year Treasury yield may end 2018 in the 2.75–3.25% range, with some volatility along the way, as growth and inflation continue to move higher.

**Despite a late-quarter rally, high-quality fixed income had a difficult start to 2018, but the ride over the remainder of the year could be smoother.** The Bloomberg Barclays U.S. Aggregate Bond Index, a good representation of the broad high-quality bond market, returned -1.5% during the first quarter of 2018. This was the 14th worst quarter since the index's inception in 1968. It could have been even worse, but the index rallied 0.5% during the last week of the quarter, offsetting some of the headwinds from earlier in the year.

## FAMILIAR FOE

Rising yields, and thus falling bond prices, have been the main cause of pain for fixed income investors year to date, as rates rose meaningfully across the maturity spectrum [Figure 1]. At shorter maturities, a deluge of Treasury supply pressed

**1 YIELDS ROSE ACROSS MATURITY SPECTRUM DURING Q1**




Source: LPL Research, Bloomberg 04/03/18

Performance is historical and no guarantee of future results.



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rates higher, as did increasing expectations for Federal Reserve (Fed) rate hikes. Rising growth and inflation expectations pushed longer-maturity yields higher throughout the quarter, with the 10-year yield reaching 2.95% on February 21, 2018, its highest level since January 2014. Long-term rates have subsided from recent highs amid equity market weakness. The 10-year yield gave back 21 basis points (0.21%) from its local high, yielding 2.74% as of quarter end.

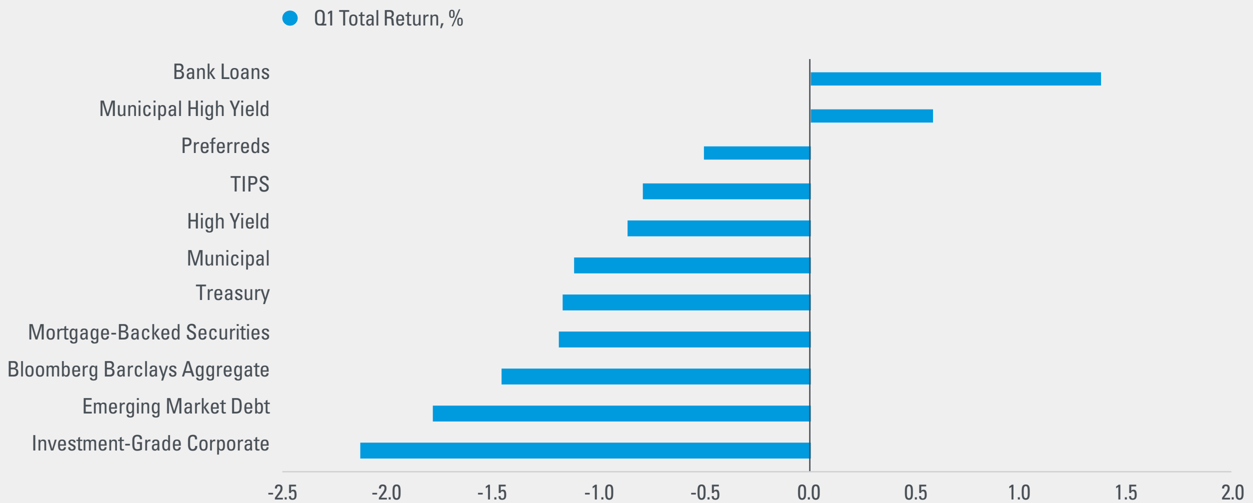
As of early February, fixed income markets were priced at what we believed to be unsustainable levels—reflecting investors' expectations for "economic perfection" (see "Will Yields Keep Rising?"). Real (inflation-adjusted) rates had risen, reflecting higher growth expectations, and breakeven inflation rates had moved higher by 40 basis points (0.40%) since early September 2017 [Figure 2].

Several factors indicated that the rise may have gone too far too fast, leading to a potential relief rally, which we have seen over the last several weeks.

## SILVER LINING

Although 2018 has been disappointing for fixed income investors thus far, the silver lining is that bonds may rebound from a total return perspective over the remainder of 2018. Scenario analysis helps inform our view that the full-year total return of the Bloomberg Barclays U.S. Aggregate will be flat to low-single digits. Based on that assessment, fixed income investors could see positive returns for the remainder of the year, as we are already above the low end of our 10-year Treasury rate estimate of 2.75–3.25% for year-end 2018.*

**2 RISING YIELDS PRESSURED FIXED INCOME DURING Q1**




Source: LPL Research, Bloomberg 04/03/18

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

## CORPORATES CRUNCHED

Investment-grade (IG) corporate bonds were the weakest performer during the first quarter of 2018, returning -2.1% in the sector's worst first quarter return in over 20 years (and 18th worst quarter on record). Some of that was due to the interest rate sensitivity of the asset class, which is elevated relative to the broad high-quality market, but widening spreads also weighed on the performance of IG corporates. While spreads in high-yield bonds have also widened, the move in IG corporates appears to have outpaced the move of lower-quality fixed income [Figure 3].

Much of the reason for that disconnect is due to an elevated supply of corporate debt. Just as Treasury yields were recently pressured higher at shorter maturities due to elevated supply from the Treasury, pent-up IG supply was released into the market that had been on hold since late 2017 due to uncertainty surrounding the new tax plan. Since the passage of the tax plan, supply has increased, and credit spreads have widened. Through February of this year, net new issuance of IG bonds was $113.6 billion. Though the market is on pace for more issuance than 2017, we don't believe it will surpass last year's record-breaking volume. This is partly because repatriation is giving firms more cash on hand to work with while the new tax law has disincentivized companies from borrowing (via the new cap on deductibility of corporate debt interest). Additionally, higher interest rates make the cost of debt more expensive and thus less appetizing for firms to issue. However, there may be some reprieve shortly, as April is historically a light issuance month and has been the best month for spread tightening over the past 10 years. We remain constructive on IG corporates due to the incremental yield over Treasuries and the solid ongoing backdrop for the global economy and corporate America specifically.

**3 AMID SUPPLY GLUT, INVESTMENT-GRADE CORPORATE SPREADS HAVE DECOUPLED FROM HIGH-YIELD SPREADS**

Source: LPL Research, Bloomberg 04/03/18

High-yield and investment-grade (IG) corporate spreads in this chart represent the yield differential between the average yield of high-yield bonds, or IG corporate bonds, and the average yield of comparable maturity Treasury bonds. Performance is historical and no guarantee of future results.

## CONCLUSION

While the first quarter of 2018 was tumultuous for many fixed income investors, some of the headwinds that we had expected this year may be behind us. We continue to believe that the 10-year Treasury yield will end 2018 in the 2.75–3.25% range, with volatility along the way, as growth and inflation continue to move higher and the Fed continues its gradual pace of data-dependent rate hikes.* We maintain that high-quality fixed income is a potential risk mitigation tool within a diversified portfolio. Market action during the most recent equity pullback (March 9, 2018 to April 2, 2018) can serve as a prime example: The S&P 500 Index lost 7.3%, while the Bloomberg Barclays U.S. Aggregate gained 0.8%, demonstrating fixed income's main role as a ballast for equity market risk in diversified portfolios. ■

*As noted in *Outlook 2018: Return of the Business Cycle*, LPL Research forecasts flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on its expectations for a gradual pickup in interest rates across the yield curve. LPL Research also expects the 10-year Treasury yield to end 2018 in the 2.75–3.25% range, based on its expectations for a modest pickup in growth and inflation.

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.

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.

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.

INDEX DESCRIPTIONS

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 Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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