LPL RESEARCH
BOND MARKET PERSPECTIVES

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BOND MARKET NOT STRESSING ABOUT HIGHER YIELDS

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KEY TAKEAWAYS

Treasury yields have seen a significant increase since early September 2017, but credit markets aren't showing any signs of stress.

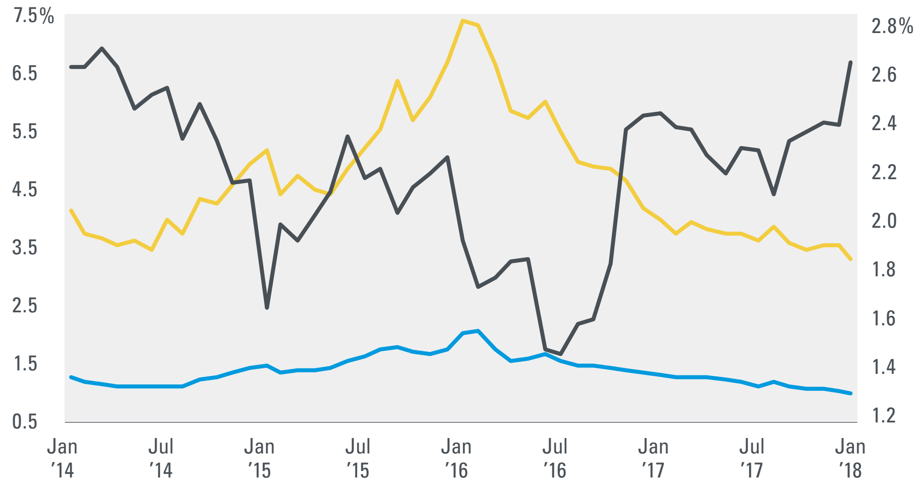
Higher Treasury yields have caused spreads on investment-grade corporate and high-yield bonds to tighten to the lowest levels of the recovery, though it's possible they could still tighten further.

Spreads have a history of staying at tight levels for long periods during economic expansions.

The 10-year Treasury yield has seen a strong move higher since September 2017, and recently surpassed its March 2017 post-election highs. A combination of higher global rates (driven by more hawkish central bank expectations), rising growth expectations due to tax reform, and an increase in inflation expectations have been the major forces driving rates higher over the past several months.

Rising rates have hurt bond prices over this period, with the Bloomberg Barclays U.S. Aggregate Treasury Index seeing a loss of 2.3% since the 10-year Treasury yield bottomed on September 7, 2017. The broader bond market has also been affected, but investment-grade corporate bonds have lost significantly less

1 INVESTMENT-GRADE CORPORATE AND HIGH-YIELD SPREADS SHOW LITTLE STRESS



Source: LPL Research, Bloomberg 01/22/18

Indexes referenced: Investment-grade bonds – Bloomberg Barclays U.S. Aggregate Credit Index; High-yield bonds – Bloomberg Barclays High Yield Bond 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.

Option-Adjusted Spreads (OAS) represent the difference between the index yield and the yield of a comparable maturity Treasury. The OAS can be used to measure the risk levels markets are placing on high-yield bonds.

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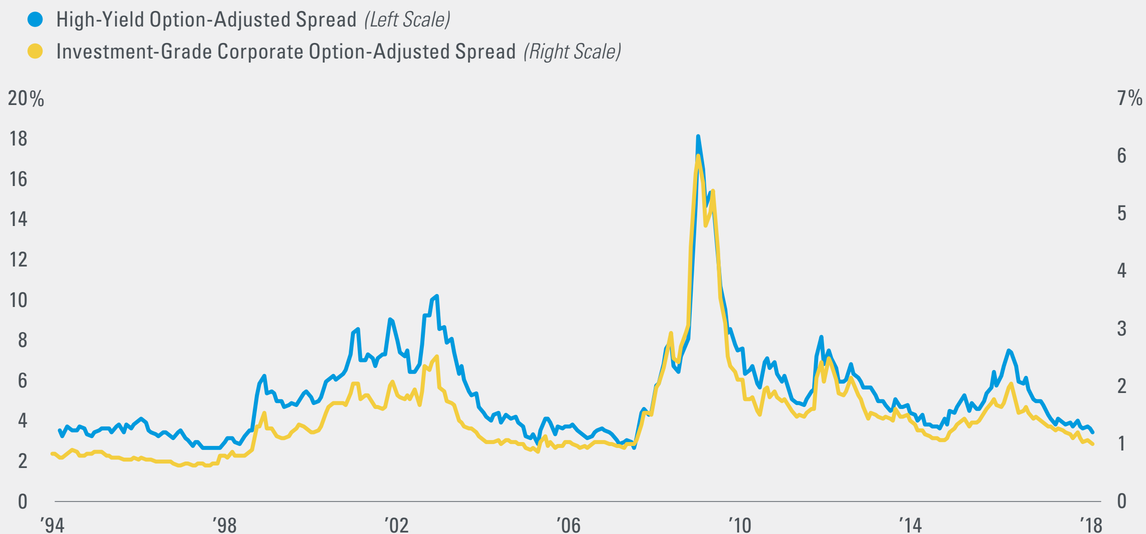
(-0.5% as measured by the Bloomberg Barclays U.S. Aggregate Credit Index) than Treasuries, and high-yield bonds have actually increased in value (1.8% as measured by the Bloomberg Barclays High Yield Bond Index), partially due to higher yields and lower interest rate sensitivity (known as duration) relative to Treasuries and investment-grade corporate bonds. Even though spreads have tightened to cycle lows, we still believe investment-grade corporate bonds offer value relative to Treasuries, and a small allocation to high-yield bonds may be appropriate for investors who are seeking the potential for additional yield and are able to deal with potentially higher risk levels.

FEW SIGNS OF STRESS

In addition to their impact on bond prices, higher rates can cause worries about the potential effect on broader economic growth. Though rates remain low relative to history, expectations of higher short-term rates (driven by Fed policy) and higher long-term rates (driven by economic growth and inflation outlooks) can cause investors to worry that higher borrowing costs for consumers and businesses could cause a slowdown in growth. However, higher rates haven't seemed to spark these concerns so far, and credit markets (and the stock market for that matter) appear to show few signs of stress [Figure 1].

2 **SPREADS CAN STAY LOW FOR LONG PERIODS OF TIME**



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Credit default swaps (CDS), which are contracts that are purchased to protect investors against the risk of default, provide another way to gauge market stress. If default expectations are increasing, those selling CDS protection may demand higher prices to compensate for the increased risk. On this front, markets also appear to show few signs of stress, as both investment-grade corporate and high-yield bond CDS spreads remain low relative to history.

SHOULD INVESTORS FEAR TIGHT SPREADS?

Yields on investment-grade and high-yield bonds have moved higher, but not to the degree that Treasuries have. This has caused spreads for both investment-grade and high-yield bonds to trade at the lowest levels of the current expansion.

Importantly, tight spreads by themselves are not necessarily a reason to fear these asset classes. Investment theory states that we should "buy low and sell high," but low rates (relative to history) and tight spreads make it difficult to say that we are buying low. However, a steady economy and low default expectations offer some fundamental support to tight spreads. And as Figure 2 shows, spreads have been even tighter than they are today and tight spreads have the potential to continue for years during economic expansions.

Even if spreads do tighten further, we believe yield may be the main driver of return for investment-grade and high-yield fixed income this year. The fundamental backdrop suggests that today's tight spreads have the potential to move marginally tighter, and could stay that way for some time before making a major move higher. However, even if spreads move tighter, we don't expect the kind of moves (and resultant capital appreciation) that we've seen in recent years for these asset classes given that spreads are lower than they were in previous years, leaving less room for compression. However, any spread tightening could partially offset the impact of Treasury yields if they move gradually higher in 2018 as we expect.

It's also important to keep in mind that the purpose of bonds in a portfolio context is to provide income and manage the risk to portfolio's value during times of equity weakness. Although high-yield bonds can offer the potential for additional income and less interest rate sensitivity than their higher-quality counterparts, high-quality corporate bonds have historically provided better protection during equity market pullbacks. As communicated in our *Outlook 2018*, we do expect stock market volatility in 2018 to increase from current historically low levels. If this happens and stocks see a pullback, there is a possibility that investors would demand additional yield from investment-grade corporate and high-yield bonds to compensate for higher perceived risk levels, causing spreads to comparable Treasuries to widen. If such a scenario were to unfold, Treasuries could perform better than investment-grade or high-yield bonds.

CONCLUSION

Although rates have risen recently, credit markets appear to show few signs of stress. We continue to believe investment-grade corporate bonds, even at tight current spreads, offer value relative to Treasuries. Where appropriate, high-yield bonds can also help provide additional income, though their higher exposure to credit risk warrants a smaller allocation in most cases. Keeping the yield and risk characteristics of these two asset classes in mind, and being mindful that (now higher yielding) Treasuries have historically provided the most protection in case of stock market weakness, can help investors balance the need for yield with the need to manage risk in down markets. ■

A credit default swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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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.

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.

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.

DEFINITIONS

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.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

INDEX DESCRIPTIONS

Bloomberg Barclays U.S. Aggregate 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).

Bloomberg Barclays U.S. Aggregate Credit Index measures the performance of U.S. dollar-denominated U.S. Treasury bonds, government related bonds, and investment-grade U.S. corporate bonds.

The Bloomberg Barclays High Yield Bond Index measures the market of USD-denominated, noninvestment-grade, fixed-rate, taxable corporate bonds. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below, excluding emerging markets debt.

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