LPL RESEARCH

BOND MARKET PERSPECTIVES

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ARE RATES STILL HEADING HIGHER?

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KEY TAKEAWAYS

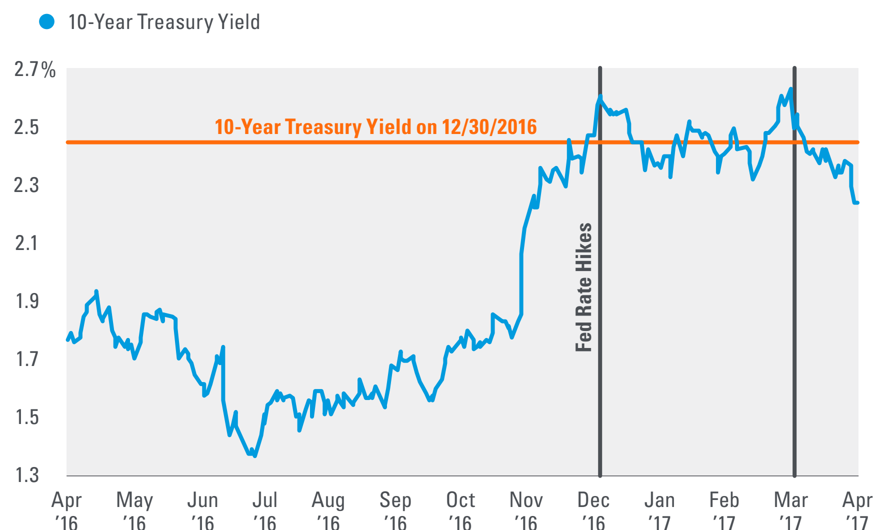
Many market participants came into 2017 believing rates would finally take a straight path higher, but this hasn't been the case.

The 10-year Treasury yield has declined by nearly 40 basis points from its mid-March high as geopolitical tensions and policy delays were exacerbated by record shorts in the Treasury market.

We continue to believe that government policy, central bank policy, and steady economic growth have the potential to push the 10-year Treasury yield higher, and that our year-end target of between 2.25% and 2.75% remains reasonable.

Many market participants had expected rates to move higher in 2017, but recent moves in the Treasury market may have some wondering if higher rates are still a foregone conclusion. The 10-year Treasury yield had been on an upward trend since the election, moving from 1.85% on November 8, 2016 (the day before the election), to a closing high of 2.62% on March 13, 2017. However, over the ensuing month rates have fallen nearly 40 basis points, closing at 2.23% on April 13. Nearly 14 basis points of that drop came last week following heightened geopolitical concerns regarding North Korea and Syria, along with dovish comments from President Trump endorsing low interest rate policy and a weaker dollar. These moves have pushed the 10-year Treasury yield to levels last seen in the aftermath of the election [Figure 1]. The 2-year Treasury, which is more directly impacted by expectations for future Federal Reserve (Fed) rate hikes, has also stalled out, and as of April 13, 2017, was basically flat for the year even though the Fed had hiked rates in March.

1 DESPITE EXPECTATIONS, THE 10-YEAR TREASURY YIELD IS ACTUALLY LOWER YEAR TO DATE



Source: LPL Research, FactSet 04/17/17

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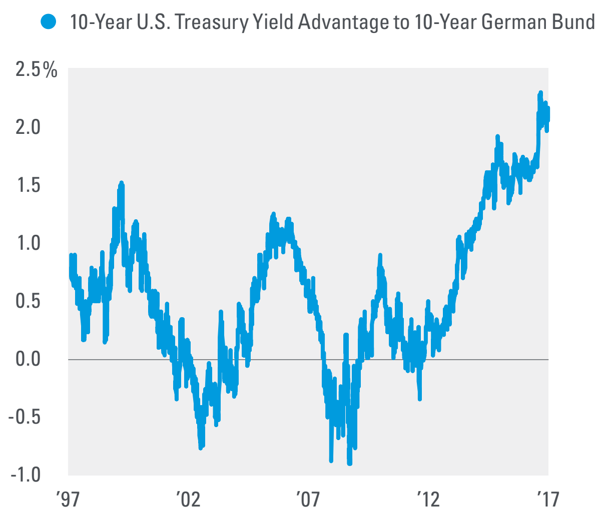
AN EXPECTED PAUSE

Our LPL Research *Outlook 2017* forecast stated that we believed the 10-year Treasury yield would end 2017 in a range between 2.25% and 2.75%, and potentially as high as 3% if meaningful fiscal stimulus were implemented.* However, we didn't believe that the path to higher rates would necessarily be direct, and over the past few months we have argued that rates may actually move lower before heading higher (see *Bond Market Perspectives* "Technical Factors" from January 10, 2017). At the time we argued that an elevated level of short positions in 10-year Treasury bonds could cause a short squeeze that would exacerbate a move lower if economic or geopolitical news were to cause a flight to safety. We saw just this sort of move last week, and at last check (as of April 11, 2017) shorts in intermediate and longer-term Treasuries have moved from all-time highs to more normal levels, though they remain elevated in shorter-term maturities.

Additionally, we noted, and continue to believe, that low international rates could restrain any move higher for rates domestically. Though rates in the U.S. remain low on an absolute level, the yield advantage of Treasuries to government bonds of other developed international markets remains high relative to history. The advantage to the 10-year German Bund has come off a recent peak, but remains near a multi-decade high [Figure 2]. The advantage to the 10-year Japanese Government Bond (JGB) is at levels last seen in 2013. The relative attractiveness of U.S. rates may continue to lure foreign investors into the Treasury market, keeping U.S. rates lower than they otherwise would be.

2 THE 10-YEAR TREASURY YIELD ADVANTAGE VERSUS THE GERMAN BUND REMAINS NEAR MULTI-DECADE HIGHS



Source: LPL Research, FactSet 04/17/17

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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 (yield advantage), the greater the difference between the yields offered by each instrument.

CAN RATES STILL MOVE HIGHER?

We have discussed the reasons why rates have stalled, but the more important question is, can rates still move higher in 2017? We believe the answer remains yes. While tax reform and fiscal spending are increasingly looking like they will come later than many market participants had expected, the Trump administration will continue to pursue its agenda and we could see a policy impact later this year or into 2018. Additionally, economic growth overall remains steady, consumer and business confidence remain strong (which can impact spending decisions), and there are few signs of a looming recession.

Equally important to the path of rates this year is the Fed. We continue to expect that the Fed will increase short-term rates at least once, and possibly twice more in 2017. Fed rate hikes affect short maturity Treasuries the most, but historically

*We expect the 10-year Treasury yield to end 2017 in its current range of 2.25–2.75%, with a potential for 3%. Scenario analysis based on this potential interest rate range and the duration of the index indicates low-to-mid single digit returns for the Bloomberg Barclays Aggregate Bond Index.

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a rate hike has at least partially carried over into longer dated maturities as well. Even if this doesn't happen, the Fed has another tool that they can use to influence rates—their $4.5 trillion balance sheet. As mentioned in last week's *Weekly Economic Commentary*, the Fed has been discussing the possibility of halting reinvestment of maturing bonds.

Most of the Fed's holdings mature in more than one year, meaning the fundamental impact of such a change would likely be minimal in the near term; but if the Fed wanted to push rates higher on any maturity in the yield curve, they could do so by selling bonds. This would be an extreme measure, and isn't one that we expect at this point in time, but it is important to remember that the Fed has policy tools at its disposal to steepen the yield curve as needed, in addition to the ability to talk rates higher.

CONCLUSION

Geopolitical tensions and a potential delay of Trump's agenda, exacerbated by record shorts in intermediate to long-term Treasuries, conspired to push rates lower over the past month. Though some of the drivers that markets had expected to push rates higher, including Trump's tax reform and infrastructure spending plans, appear to be delayed, this doesn't mean that they won't have an impact on markets later this year or next. Meanwhile, economic growth remains steady and confidence measures, which can impact spending decisions, remain strong as well. Given this backdrop, we continue to believe that rates may move at least moderately higher over the course of 2017, and that our year-end target of a 10-year Treasury yield in the range of 2.25% to 2.75%, with the potential for as high as 3% if meaningful fiscal stimulus is enacted, remains reasonable. ■

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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.

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