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TANTRUM BREWING?

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KEY TAKEAWAYS

We do not see the recent rise in Treasury yields as the start of another "taper tantrum" bond sell-off.

Several diverse factors pushed Treasury yields higher last week, but their ability to persist is questionable.

Our overall expectations for fixed income have not changed due to this move.

THE TAPER TANTRUM

The taper tantrum from May through September 2013 was spawned by Fed Chair Ben Bernanke's mention of a reduction in bond purchases by the Fed. This hawkish signal drove rates higher, with the 10-year Treasury yield moving up by 1.08% (from 1.70% to 2.78%) from the beginning of May to the end of August 2013.

We do not see the recent increase in Treasury yields (including a +0.11% increase on the 10-year Treasury last week) as the beginning of another taper tantrum. Circumstances are different this time around: European and Japanese yields helped to lead this increase, unique domestic forces also contributed, global central banks should remain powerful forces, and the Federal Reserve (Fed) has maintained that its rate hike trajectory will remain gradual. Additionally, the market today is much more prepared for a rate hike than it was in 2013.

DIVERSE DRIVERS

A flurry of forces hit Treasury markets last week, all contributing to the rise in interest rates:

- **Hawkish Fed speak.** Noted Fed doves, Fed regional bank presidents Rosengren and Tarullo, suggested that a rate hike is warranted. Their comments caught investors off guard and sparked fears of a faster pace of near-term rate hikes.
- **ECB on hold.** The European Central Bank (ECB) did not lower interest rates further and did not expand existing bond purchases, nor gave hints of either occurring in the future, suggesting that easy monetary policy may be gradually coming to an end.
- **BOJ talks yield curve.** The Bank of Japan (BOJ) announced that it was studying ways to steepen its yield curve by increasing very long maturity bond yields from extremely low levels.
- **Corporate new issuance.** Corporate bond markets saw the biggest week of new issuance ($65B) in over 15 years, as companies rushed to market ahead of uncertainty surrounding the timing of Fed rate hikes. Heavy corporate issuance can pressure Treasury markets, as bond underwriters often sell Treasuries to hedge leftover inventory. The fact that this remarkable issuance occurred over only four days in the shortened holiday week made it an even more impactful.
- **Treasury complacency.** Treasury markets had grown complacent, with volatility remaining muted throughout August through the beginning of September, potentially leaving markets more vulnerable to swings.
- **Fiscal stimulus?** Talk of fiscal stimulus to boost economic growth has increased, as global central bankers discuss the limits of monetary policy's effectiveness. Fiscal stimulus would be a negative for fixed income, all else equal, as it would likely boost expectations for growth and inflation, and, if funded by issuing more debt, could increase the amount of debt outstanding.

As a result, the 10-year Treasury yield increased by 0.13% over the last two days of last week (September 8–9). Although this is a meaningful increase, in our opinion this is not the beginning of another bond market sell-off on par with the taper tantrum.

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LULLED INTO COMPLACENCY

Treasury yields traded in a very tight range in August 2016, with the 10-year Treasury trading in a range of just 0.13%. The average monthly range of the 10-year Treasury over the last 30 years has been nearly three times that, at 0.37%. The period prior to the taper tantrum showed similarly low volatility prior to the dramatic rise in yields. At the end of April 2013, the 10-year yield had been in a range of 0.19% for the previous month. A sustained period of low volatility, defined by limited daily yield changes, can often reflect investor complacency and leave prices vulnerable to sharp swings.

Although this backup in yields seems large, a two-day increase in the 10-year yield of 0.13% or more is not uncommon. Over the last 30 years, almost 7% of all two trading day stretches have included an increase of this magnitude or larger. So while it seems like a major move in today's market, it is hardly a rare occurrence.

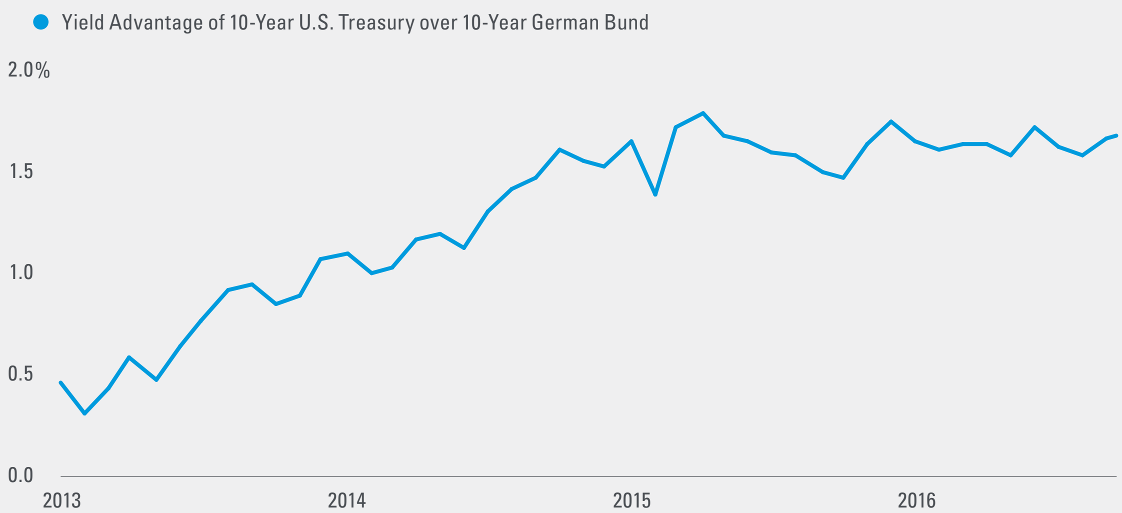
NOT A TAPER TANTRUM REPEAT

There are several reasons why we do not expect a repeat of the taper tantrum: central bank support, rate hike expectations, and sluggish economic growth.

Central Bank Support

We expect global central banks to remain accommodative and help support low yields across the global fixed income landscape. Treasury yields remain strongly influenced by overseas markets. The fact that Treasury yields followed European and Japanese yields higher on the heels of the ECB's inaction and BOJ's curve steepening talk confirms their impact. The ECB or BOJ appear unlikely to alter overnight lending rates anytime soon, and they still provide support for U.S. bonds. The 10-year Treasury still resides near a 1.6% yield advantage relative to the 10-year German government bond. This gap is just over 1% wider now than at the start of the taper tantrum bond sell-off [Figure 1]. While overseas events may have shaken investors out of a

1 U.S. TREASURIES' YIELD ADVANTAGE TO GERMAN BUNDS COULD HELP PREVENT A TANTRUM



Source: LPL Research, FactSet 09/09/16

Performance shown is historical and no guarantee of future results.

complacent state, broad policy appears unlikely to change soon enough to drive a rapid and quick rise in bond yields.

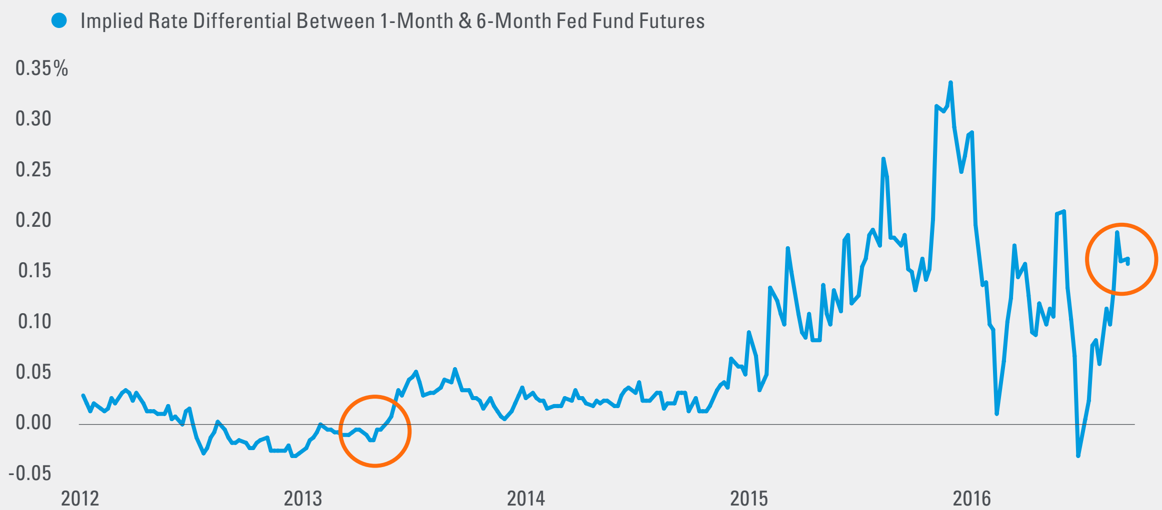
Rate Hikes Are Expected

Today's market is more prepared for rate hikes than in 2013. Differences between fed funds futures contracts indicate how much Fed action the markets are expecting. Currently, the implied rate differential between one-month and six-month fed fund futures contracts suggests markets are pricing in a 0.16% increase [Figure 2]. Pre-taper tantrum, markets were implicitly pricing in a slight decline in the fed funds rate. Although futures may be downplaying the pace of rate hikes relative to what the Fed is forecasting in 2016, this is still a sharp contrast to 2013, when futures reflected more market-friendly policy based on expectations of lower six-month rates. A market on guard for a rate hike is much less likely to be shocked by one, and thus potentially less likely to produce a significant and prolonged sell-off like we saw in the taper tantrum.

Economic Growth Is More Sluggish

A rebound in gross domestic product (GDP) is expected over the third and fourth quarters of 2016; however, the pace of domestic economic growth is weaker compared to 2013. In 2013, GDP growth averaged 2.7%, while the pace over the first half of 2016 is 1.0% and may not reach the 2013 pace even with a 3.5% growth rate over the second half of 2016.

2 MARKETS ARE MORE PREPARED FOR A RATE HIKE NOW THAN PRIOR TO THE TAPER TANTRUM



Source: LPL Research, FactSet 09/09/16

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Differences between fed funds futures contracts indicate how much the markets are expecting a change in the fed funds rate.

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STILL A LOW-RETURN ENVIRONMENT

We still expect the 10-year Treasury to end the year near 1.75%, as noted in the *Midyear Outlook 2016: A Vote of Confidence,* with total returns for broad fixed income in the range of low- to mid-single-digits.* This week's Treasury auctions and lingering uncertainty ahead of next week's Fed meeting may keep pressure on high-quality bond prices, but at most, we envision a new trading range of 1.6–2.0%. While yields may oscillate in that new range, the main message for investors has not changed: We expect fixed income returns to be muted over the second half of 2016.

* We have increased our full-year 2016 total return forecast for high-quality bonds to a low- to mid single-digit total return, up from flat. A reduced number of Fed rate hikes, continued aggressive policy easing by overseas central banks (most notably the European Central Bank and Bank of Japan), and below-trend economic growth translate to a more supportive backdrop for bonds globally. We expect limited bond returns over the second half of 2016. Expensive valuations and low yields may remain in place.

CONCLUSION

The rise in Treasury yields last week was jarring for some investors, as yields had remained tightly range bound in the weeks leading up to it. The larger context for this move and the market's greater preparedness for rate hikes compared to 2013, however, lead us to believe that recent rate moves are unlikely to be the start of another taper tantrum. ■

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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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