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FOURTH QUARTER PREVIEW: DÉJÀ-VU?

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KEY TAKEAWAYS

The Federal Reserve is pointing to a December rate hike in 2016, similar to last year, but yields are lower and prices are higher than this time last year.

Economically sensitive sectors have historically weathered rate hikes better than their high-quality counterparts, but more expensive valuations warrant caution.

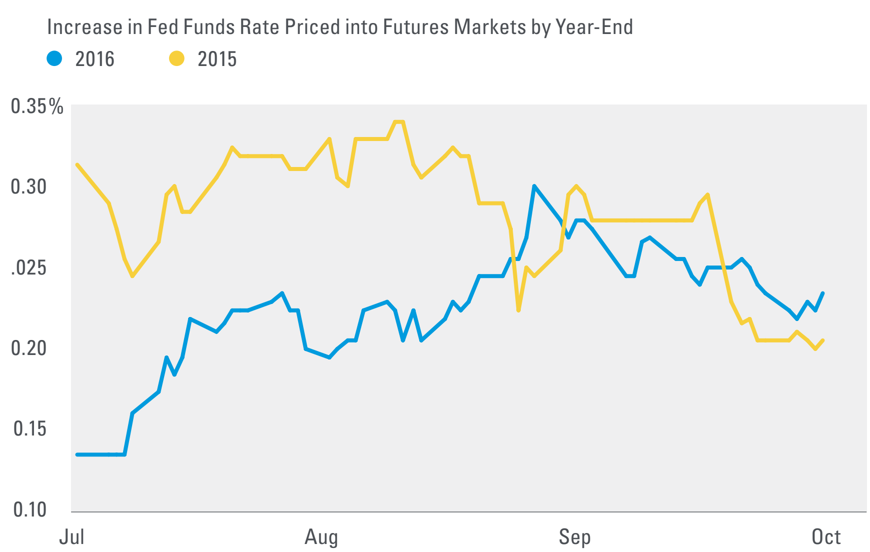
Volatility in fixed income markets will likely re-emerge in the fourth quarter, as the presidential election overhang may keep markets on unstable footing.

With the Federal Reserve (Fed) pointing to another December rate hike, investors may be getting a sense of déjà vu. Although the grand arc of the Fed story may be the same, conditions in fixed income markets outside of a potential hike have changed. We preview what may be in store for fixed income markets in the fourth quarter of 2016.

RATE HIKE EXPECTATIONS

In addition to the presidential election, the Fed meeting in December will likely be a main driver of fixed income markets in the fourth quarter. During the third quarter, fixed income markets increasingly priced in a rate hike in December [Figure 1]. The difference between fed funds futures contract rates and the current fed funds rate can indicate how much Fed action markets are expecting. Currently, the implied rate differential between the December 2016 contract

1 FED FUNDS FUTURES INDICATE MARKET IS SLIGHTLY MORE PREPARED FOR A RATE HIKE THIS YEAR THAN LAST



Source: LPL Research, Bloomberg 10/03/16

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and the current fed funds rate suggests markets are pricing in a 0.23% increase in the next three months. At this same time last year, markets were pricing in a 0.20% increase in the subsequent three months. Additionally, the trend in 2015 had been downward, indicating that investors had been incrementally discounting a December rate hike during the third quarter. In the third quarter of 2016, by contrast, investors have been gradually increasing their expectations of a December hike.

Because a market on guard for a rate hike is much less likely to be shocked by one, we believe this adds to the case that although rates may rise in response to a December rate hike, they may not rise violently, as witnessed in the taper tantrum of 2013.

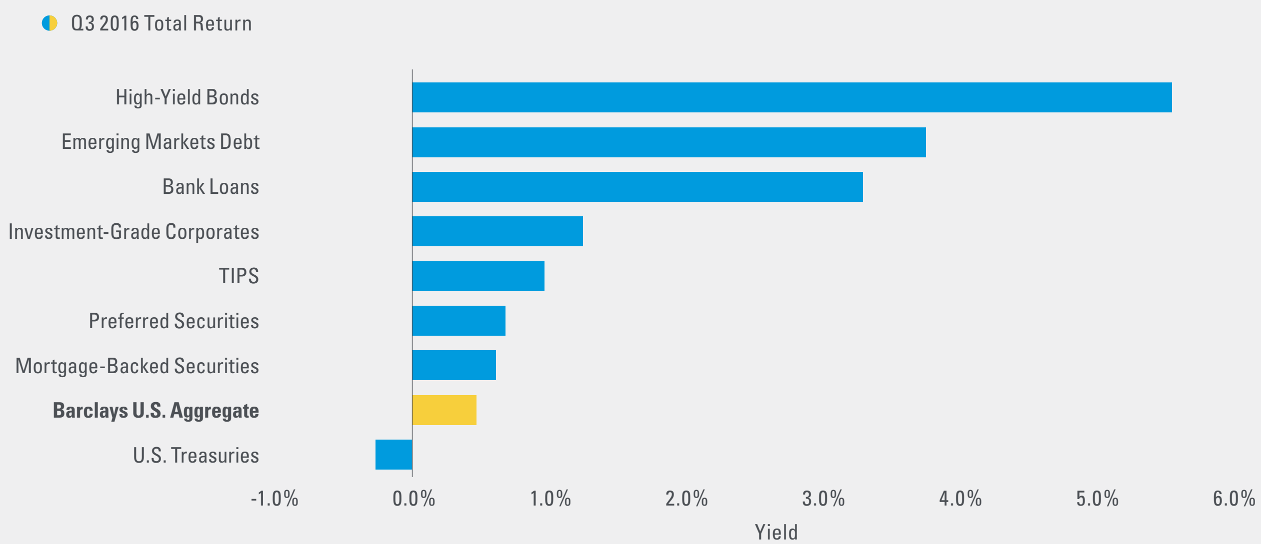
SOME CAUTION IS WARRANTED

Economically sensitive sectors have historically weathered periods of interest rate hikes better than their high-quality counterparts, but richer valuations relative to a year ago warrant caution. During the third quarter of 2016, economically sensitive sectors of the fixed income market performed well [Figure 2].

As valuations in these sectors have continued to increase, their susceptibility to pullbacks logically increases as well. High-yield, for instance, which we believe to be on the expensive side of fair value at this point, enjoyed a 5.6% total return in in the third quarter, bringing its year-to-date return to 15.1% (based on the Barclays US High Yield Index).

Managed futures strategies use systematic quantitative programs to find and invest in positive and negative trends in the futures markets for financials and commodities. Futures and forward trading is speculative, includes a high degree of risk that the anticipated market outcome may not occur, and may not be suitable for all investors.

2 ECONOMICALLY SENSITIVE SECTORS OF FIXED INCOME CONTINUED THEIR IMPRESSIVE RALLY



Source: LPL Research, Bloomberg 10/03/16

Indexes referenced are Barclays U.S. High Yield Index, JPMorgan EMBI Global Index, Barclays U.S. High Yield Loan Index, Barclays Corporate Index, Barclays U.S. Treasury Inflation Protected Notes Index, BofA Merrill Lynch Hybrid Preferred Securities Index, Barclays U.S. Aggregate Securitized MBS, Barclays U.S. Aggregate Bond Index, Barclays US Aggregate Government Treasury Index.

Indices are unmanaged index 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.

As market concerns of Fed rate hike implications mounted in the fourth quarter of 2015, high-yield was hit hard, returning -2.1% during the quarter. The decline in the price of oil was certainly the main cause, but the added layer of uncertainty around Fed rate hikes exacerbated that weakness.

The pattern in emerging markets debt (EMD) is similar to that of high-yield: weakness pre- and immediately post-Fed rate hike last year, followed by a strong rally for most of 2016, and valuations that are richer now than they were at this time last year [Figure 3]. This is one reason we believe these sectors should only be used as a small complement to high-quality fixed income. Although they add meaningful yield to fixed income portfolios, current conditions argue for caution entering the fourth quarter.

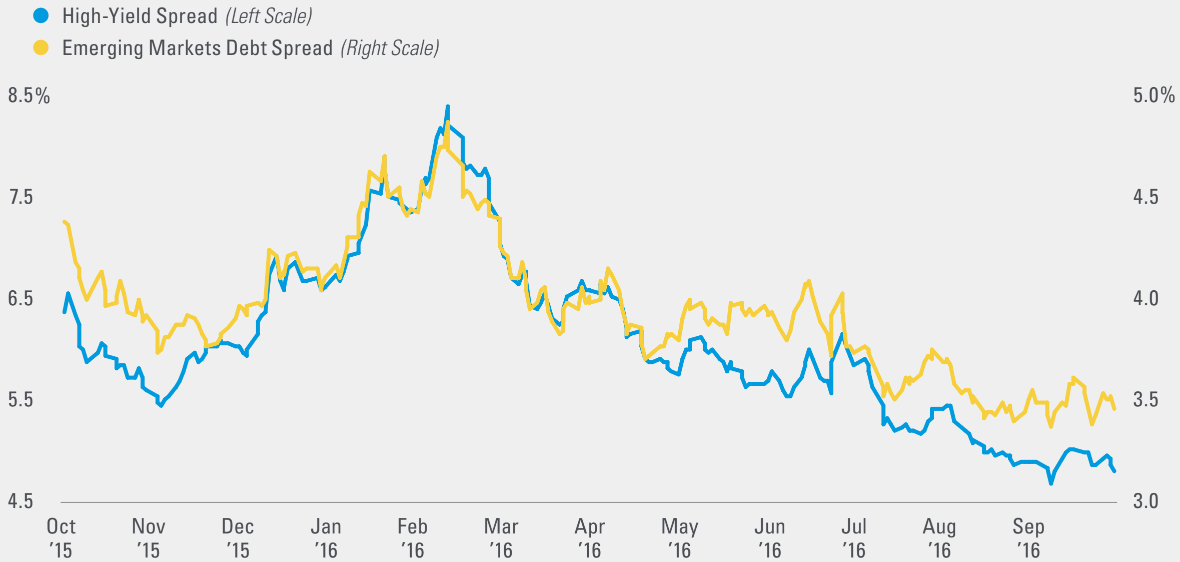
OTHER OPPORTUNITIES

With rates poised to rise in the fourth quarter of 2016, albeit modestly, several sectors stand to potentially benefit.

Bank Loans

Rising short-term interest rates were a tailwind for bank loans over the third quarter of 2016, returning 3.3%. Increasing market conviction in a December 2016 rate hike would likely push short-term yields higher over the fourth quarter. Bank loans could stand to benefit, as London Interbank Offered Rate (Libor) (0.85% as of September 30, 2016), the base rate for many bank loans, could be pushed above the 1% floor above which the majority of issues would start to float with rising interest rates.

3 **HIGH-YIELD AND EMD VALUATIONS HAVE RICHENED RELATIVE TO ONE YEAR AGO**



Source: LPL Research, Bloomberg 10/03/16

Indexes referenced are Barclays U.S. High Yield Index and JPMorgan EMBI Plus Index.

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. High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

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

Mortgage-Backed Securities (MBS)

Although Treasury yields may rise over the quarter, we expect them to remain largely range bound for the time being. Volatility may also rise during the quarter, but we still maintain our estimate for the 10-year yield to be in the 1.50–1.75% range at year end. A range-bound rate environment may be supportive of MBS, where they can add incremental value against such a backdrop. In the event of modestly rising rates, MBS could also show their strength as the sector boasts a high ratio of yield per unit of duration (interest rate sensitivity) relative to other high-quality fixed income options.

THE SCRIPT MAY FLIP

Election-related volatility, further weakness in European banks, or other unforeseen events may throw a wrench in the Fed's presumed plan to hike rates this year. Although our base case remains that the Fed will hike rates in December 2016, it is important to remember that this is not set in stone, and the Fed has held off previously in response to market-destabilizing factors. The Fed did so in response to equity market weakness following China's currency devaluation in its September 2015 meeting and Brexit-related concerns in its September 2016 meeting.

For more of our views on expected volatility in the fourth quarter, please see this week's *Weekly Market Commentary*, "Welcome to the Fourth Quarter."

CONCLUSION

Market sentiment largely indicates, and we concur, that the Fed is on track to hike interest rates in December. Futures markets implicitly indicate that fixed income markets are doing well to prepare for this. However, it is important to note that valuations are more expensive across most of the fixed income markets relative to one year ago, leaving more room for volatility or weakness in the fourth quarter. The additional layer of a dynamic presidential election also may increase volatility, leading to a fourth quarter that could be anything but boring in fixed income markets. ■

Mortgage-backed securities are subject to credit, default, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, market and interest rate risk.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

Preferred stock investing involves risk, which may include loss of principal, and are subject to many of the same risks which affect fixed income securities.

INDEX DESCRIPTIONS

The 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 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 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 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 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 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 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 JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

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.

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