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BONDS TO FED: READY, SET, HIKE

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KEY TAKEAWAYS

Positive economic data contributed to a rise in Treasury yields last week, a positive sign for the economy but painful for fixed income investors.

Trends in fixed income markets signal that the economy is in good shape to weather a potential Fed rate hike in December.

With over six weeks to go until the Fed's December meeting, these positive indicators could reverse due to political uncertainty or other global events.

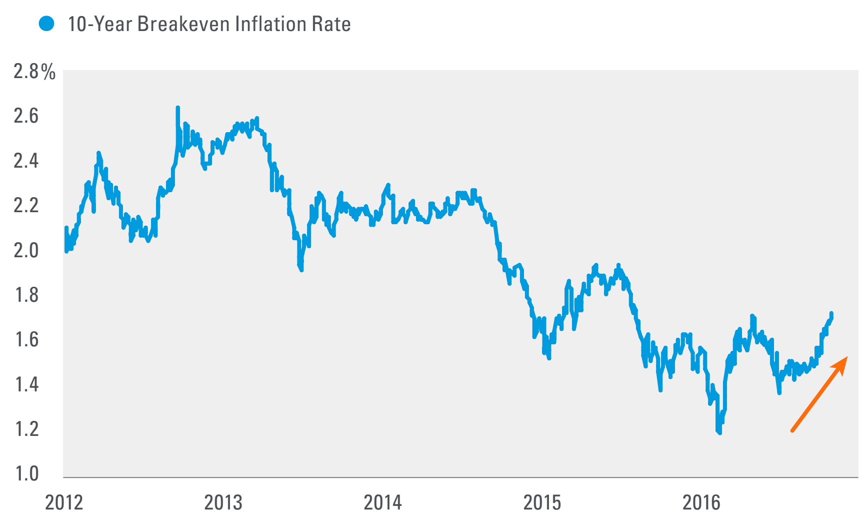
A slew of good data last week sent reverberations through the bond market, with yields rising and the market increasingly signaling to the Federal Reserve (Fed) that the economy is prepared for a rate hike in December. Bond market internals are increasingly telling the story that the economy is picking up steam and may be ready for a rate hike based on inflation expectations, the steepness of the Treasury yield curve, and fed fund futures market-implied rate hike expectations. While this past week may have been painful for fixed income investors across most sectors due to the overall rise in interest rates, the bond market provided positive confirmation about the state of the U.S. economy.

DRIVEN BY SOLID DATA

Economic data during the third quarter of 2016 were mixed, not good enough to prompt a rate hike in September 2016, yet good enough to build the case for an increase in December 2016 and trending more positive of late. Last week

Inflation is recovering from the depressed levels of the last year.

1 INFLATION EXPECTATIONS HAVE BEEN PICKING UP STEAM



Source: LPL Research, Bloomberg 10/31/16

Breakeven inflation is a measure of the difference between Treasury yields and Treasury Inflation-Protected Securities (TIPS) yields.

Performance is historical and no guarantee of future results.

alone, the market digested strong Markit services and manufacturing readings, a solid durable goods report, and a good jobless claims figure. Most importantly, the third quarter initial gross domestic product (GDP) reading on October 28, 2016 provided an upside surprise on domestic growth. Year-over-year growth of 2.9%, which topped the 2.5% consensus estimate, is an encouraging sign for the Fed, which had worried about the fragility of the economic recovery given its desire to continue to raise interest rates.

INFLATION EXPECTATIONS

The Fed has been grappling with the challenge of hiking rates amid a backdrop of declining inflation expectations, which fell during the second quarter of 2016 and remained muted throughout the third quarter. It seems that expectations are finally gaining traction with improving economic data and starting to head northward. Inflation expectations can actually help drive inflation, and market-implied expectations are providing an important signal that inflation is recovering from the depressed levels of the last year [Figure 1].

The 10-year breakeven inflation rate reached 1.74% on October 28, 2016, the highest level since July 31, 2015. Inflation and inflation expectations have been obstacles for the Fed in prior considerations to raise rates. The recent pickup has been a welcome sign for a Fed looking to continue its rate hike trajectory after pointing for months to a rate hike in December 2016.

RATE HIKE EXPECTATIONS

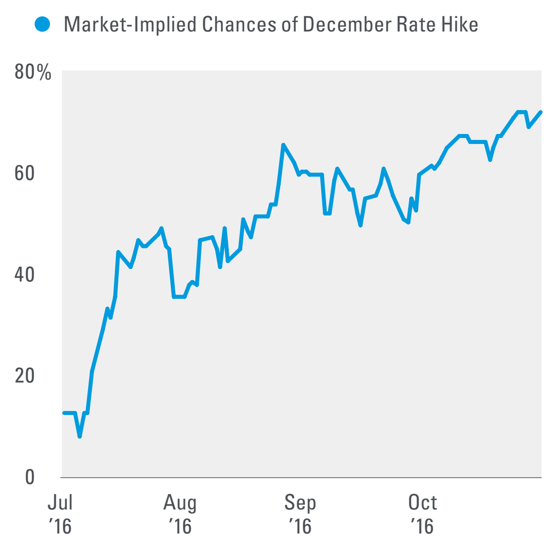
Rate hike expectations have been pushing higher with yields in recent months, another sign the market is increasingly growing comfortable with the prospects of a December hike. Historically, market-implied odds of a rate hike have usually been at least 60% when the Fed raised rates, due to market participants' largely sound understanding of what the Fed is looking at when deciding on an action. The Fed often wants to avoid shocking the markets with a surprise hike, leading to potential extreme market reactions and unintended consequences.

Markets are currently pricing in a 73% chance of a hike in December (as of November 1, 2016). Given the potential for volatility over the next six weeks due to the presidential election, or any unforeseen destabilizing global event that could derail the Fed's assumed course, that chance is probably close to as high as it could reasonably be at this point [Figure 2].

STEEPENING YIELD CURVE

Fed rate hikes affect the shorter-maturity end of the Treasury yield curve more than the longer end, which is driven more by expectations of economic growth and inflation. The differential between these two can be seen as a proxy for the health

2 MARKET IS INCREASINGLY PRICING IN DECEMBER RATE HIKE



Source: LPL Research, Bloomberg 10/31/16

The market-implied chances of a rate hike are calculated based on pricing of various fed funds futures contracts.

of the economy. Yield curve steepness increased during October and is at its highest level in five months. A steeper yield curve is a signal that the market anticipates faster economic growth and inflation, and that the economy may be able to weather a rate hike at this stage without hindering economic growth. [Figure 3].

PAIN OF GOOD MESSAGES

What's good for the economy can be bad for bonds. Rising expectations for growth and inflation, and the Fed raising rates in response, can and likely will pressure bond prices. This is especially true of higher-quality segments of the bond market that are more sensitive to interest rates. So while economic improvement is good for investors overall, it has created pain in their fixed income portfolios. The broad bond market, represented by the Barclays US Aggregate Index, returned -0.8% during October 2016, its worst monthly return since June of 2015 when the index returned -1.1%.

These yield curve shifts have affected segments of the bond market differently, as shown by October returns for the Barclays US Aggregate relative to its underlying components [Figure 4].

Treasuries and government-related debt performed worst, while securitized debt, 93% of which is mortgage-backed securities (MBS), performed best. Different components have different interest rate sensitivities and MBS, which we like for its impressive ratio of yield relative to duration (a measure of rate sensitivity), exemplified that preference by holding up well in October's rising rate environment.

Investment-grade corporates are more interest-rate sensitive than the broad bond market, yet performed roughly in line with the broader market due to richening valuations that reflected improving strength in the domestic economy. The spread of investment-grade corporates to Treasuries declined during the month, helping to soften the blow of rising interest rates. Although the rise in interest

3 YIELD CURVE IS FINALLY STEEPENING AFTER LONG FLATTENING TREND

Source: LPL Research, Bloomberg 10/31/16

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rates was painful for fixed income investors, the underlying messages were positive for the domestic economy.

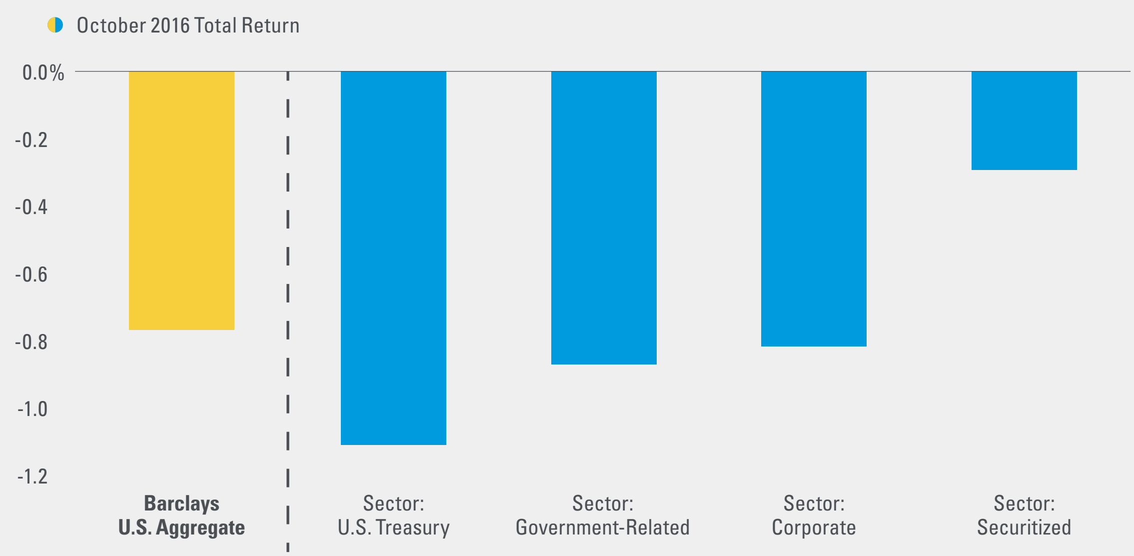
MARKETS CAN TURN

Despite the aforementioned signals, a lot can change in the six weeks leading up to the Fed's meeting on December 13–14, 2016. The FBI's recently announced investigation into more of Hillary Clinton's emails was enough to reduce December market-implied rate hike expectations by about 5% intraday, falling to 69% from 74%. Although those chances have recovered back into the 70%+ range to start this week, it goes to show how non-market forces can affect market expectations. This week alone contains many data points that could shift market sentiment: continued S&P 500 earnings, the Institute for Supply Management (ISM) manufacturing report, a jobs report, and a Federal Open Market Committee (FOMC) meeting on November 1–2, 2016. Though the chances of a hike in the November meeting are low (16% as of November 1, 2016), language from the meeting statement could still guide markets.

CONCLUSION

October was challenging for fixed income markets as Treasury yields rose across the maturity spectrum. Underneath this, however, are positive signs about the strength of the domestic economy. A steepening yield curve, and rising inflation and rate hike expectations are signs that fixed income markets believe the economy may be in good shape for a potential Fed rate hike in December. ■

4 OCTOBER PERFORMANCE SHOWS HOW IMPACT OF RISING RATES DIFFERS AMONG FIXED INCOME SECTORS



Source: LPL Research, Barclays, Bloomberg 10/31/16

Past performance is not an indication of future results.

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).

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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.

Mortgage-backed securities are subject to credit, default risk, 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, and interest rate risk.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

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.

INDEX DESCRIPTIONS

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