LPL RESEARCH

BOND MARKET PERSPECTIVES

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# 2016 HITS AND MISSES: FIXED INCOME EDITION

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## KEY TAKEAWAYS

Total returns for the broad bond market year to date are within our midyear forecast of low- to mid-single-digits.

Sectors that we liked, including mortgage-backed securities (MBS), investment-grade corporates, high-yield bonds, and bank loans performed well, though staying neutral on emerging market debt (EMD) was a miss.

We did not anticipate the steep rise in rates following the U.S. presidential election, leading to the 10-year Treasury yield exceeding our forecast.

**As the year winds down, our weekly commentaries have reviewed how 2016 forecasts played out, and we do the same this week with a review of fixed income.** The year 2016 saw extremes in the bond market, such as low to negative rates overseas, along with major macro events (e.g. the Brexit vote) that pulled U.S. rates lower during the first half of the year, until the 10-year Treasury reached an all-time low of 1.36% in July. From then on, improving economic data and rising inflation expectations helped push rates modestly higher, before they spiked on hopes of tax reform and pro-business policies following the election in November, and again moved higher following last week's Federal Reserve (Fed) interest rate hike.

Here we review what we got right, as well as the misses for fixed income in 2016.

## WHAT WE GOT RIGHT

### Bond Market Forecast

> "Our expectation is that average intermediate-term Treasury yields rise by approximately 0.25% to 0.50%, with a lesser probability of a 0.75% increase possible." —*Midyear Outlook 2016*

We started the year with our *Outlook 2016* calling for flat returns for bonds, with expectations of a 0.25–0.50% increase in the 10-year Treasury yield from its November 2015 level of approximately 2.25%. Our rate forecast turned out to be in line with reality (the 10-year Treasury yield closed at 2.54% on 12/19/16), but the path to higher rates was unexpected. Given the low rate environment at midyear, we upgraded our total return view to low- to mid-single-digits in our *Midyear Outlook*. The Bloomberg Barclays Aggregate Bond Index has returned 1.52% as of 12/16/16, making it likely that full year total returns may finish within that updated range. We expect the 10-year Treasury yield to end 2017 in the mid 2% range, with a potential for more upside if meaningful stimulus is enacted. 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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## MBS and Investment-Grade Corporate Bonds

> "Amid historically low yields, intermediate bonds, with an emphasis on mortgage-backed securities and investment-grade corporate bonds, provide diversification benefits and a favorable trade-off between yield and interest rate risk."
> —*Midyear Outlook 2016*

> "MBS are fairly valued but offer the potential for additional yield relative to duration when compared with other high-quality options."
> —"Time to Buy Mortgages?" *Bond Market Perspectives*, May 17, 2016

A strong environment for credit and higher yields than the Bloomberg Barclays Aggregate Bond Index has helped investment-grade corporate bonds (+4.70%, Barclays Aggregate Credit Index as of 12/19/16) outperform the broader bond market year to date. MBS had a tough first half of the year as rates moved lower, but their lower duration (interest rate sensitivity) and higher yield per unit of duration helped them outperform the broader bond market in the second half of the year, as the 10-year Treasury yield climbed from all time lows reached in July (-1.59% for the Barclays Securitized MBS index versus -1.76% for the Barclays Aggregate Index from 7/8/16 through 12/19/16). Moving forward, we continue to believe that investment grade corporate bonds offer value relative to Treasuries. One risk factor to watch for MBS is that as rates rise, fewer people refinance, which could lengthen the average maturity of mortgage loans and increase duration of MBS. However, the yield per unit of duration remains attractive at this point in time, and we maintain a positive view of MBS.

## High-Yield Bonds and Bank Loans

> "With defaults likely to remain low by historical standards in 2016 and valuations adequately compensating for rising default risks, we find value in high yield bonds, a sector that has historically offered a buffer against rising interest rates."
> —*Outlook 2016*

> "Investors in bank loans may benefit if Libor continues to rise, given that the floating rates may start to move higher once the 1% Libor floor that many issues carry is exceeded."
> —"A Deeper Look at the Rise in Libor," *Bond Market Perspectives*, August 30, 2016

High-yield bonds have been the best-performing asset class within fixed income year to date, with a total return of 16.4% as of 12/16/16 (Barclays High Yield Bond Index). In addition to beneficial credit fundamentals and low defaults, high yield's correlation to oil prices, which had hurt the asset class previously, turned into a benefit as oil prices started stabilizing in 2016. With the price of oil currently above $50/barrel, spreads to comparable Treasuries have compressed significantly. However, we now believe the high-yield market is pricing in much of the improved economic outlook and potential benefit from pro-growth policies under Trump, leaving less room for error in the asset class.

We upgraded our view on bank loans in late August, as markets started to price in the impact of money market reform (which went into effect in October 2016), causing Libor* to move higher. Most bank loans adjust their coupon payments based on a spread to Libor, and many have a floor of 1%. This means that bank loan investors have been receiving the floor rate instead of the ultra-low Libor rates, which is a benefit on a total return basis. However, one of the major advantages of bank loans is that coupon payments adjust based on moves in Libor, and depressed Libor levels meant that the asset class wasn't truly floating, lessening its benefit in a rising rate environment. For the first time since May 2009, Libor is now near 1%, meaning that any further moves higher in rates could result in bank loan yields moving higher, and rates truly floating.

*London Interbank Offered Rate (Libor): An interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The Libor is fixed on a daily basis by the British Bankers' Association.

## WHAT WE MISSED

Although we had a number of hits during 2016, we also had a few misses. Like much of the market, we misjudged the market's reaction to Trump's presidential victory in November. We expected that equity markets would pull back, and bonds would rally (sending rates lower) given the uncertainty around Trump's policies. This exact scenario played out on election night with U.S. stocks pulling back as much as 5% pre market (overnight November 8-9) as Trump gained ground, but quickly reversed early the next morning (11/09/16). The 10-year Treasury yield went on to gain 0.34% for the week (moving from 1.81% to 2.15%), the largest relative upward move since records started in 1962. Rates have since continued to move higher as a string of better than expected economic data and the impact of the Fed's recent rate hike have become priced in.

Though many of our sector calls outperformed the broad bond market, EMD, an asset class we remained neutral on, also saw significant outperformance for the year, returning 9.24% year to date (JP Morgan EMBI Index). EMD benefitted from stabilizing oil prices, along with a continuation of loose monetary policy from major overseas central banks, though we continue to be neutral on the asset class overall as the potential impact of changes to trade policy from the incoming Trump administration are still unknown.

## CONCLUSION

The year 2016 was volatile for fixed income markets, but our midyear total return target appears to be on track. High-quality longer duration sectors saw strength as rates fell early in the year, but economically sensitive areas of the market, as well as those with shorter durations, tended to outperform as rates rose in the second half of the year. Our sector positioning, with a focus on investment-grade corporate bonds, MBS, high yield, and bank loans outperformed the broader market; however, we also missed the strong performance in EMD by staying neutral on the asset class and we failed to forecast the impact of Trump's election. Overall our fixed income forecasts performed well for 2016, and we hope for more hits than misses in our soon-to-be-released *Outlook 2017*. ■

The *Bond Market Perspectives* will not be published on December 27, 2016. Look for our next publication on January 3, 2017. We wish you all a joyous holiday season!

## 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.

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.

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.

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.

Floating rate 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.

International debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

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 DEFINITIONS

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. Aggregate Credit 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. Aggregate Securitized 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. High-Yield 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 market debt.

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.



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