LPL RESEARCH
BOND MARKET PERSPECTIVES

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2017 FIXED INCOME OUTLOOK:
DESPITE LIFTOFFS, EXPECT MUTED BOND RETURNS

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KEY TAKEAWAYS

Upward trending economic growth and inflation, in addition to Fed rate hikes, may put pressure on high-quality bond prices in 2017.

Fixed income allocations should nonetheless be maintained as they play a vital role in suitable investors' portfolios, despite prospects of low returns.

Muted returns for high-quality fixed income may await investors in 2017. Higher rates of economic growth and inflation, along with our base case of two potential Fed rate hikes, may put bond prices under pressure in 2017, leading to muted returns for high-quality fixed income. Amid this backdrop, most of the return potential for bonds may lie in their income component, or "coupon." Immediately following the election of Trump and a Republican majority in both houses of Congress, interest rates rose and the Treasury yield curve steepened as the market digested increased prospects of fiscal stimulus through spending and tax cuts and their potential impact on economic growth and inflation, two of the key drivers of interest rates. Low and negative yields on sovereign bonds in international developed markets, however, may continue to put downward pressure on U.S. yields, limiting the future strength of the post-U.S. election run-up in rates as 2017 begins. The restraining effect of international rates could become larger if concerns about the erosion of the EU continue, as in the case of Brexit, potentially forcing the European Central Bank (ECB) to expand or extend quantitative easing. Nevertheless, for rates to reverse meaningfully, we would likely need to see the onset of a recession in the U.S. in 2017, a scenario we believe to be unlikely.

GAUGING GRADUAL PROGRESS

Despite our expectation for muted bond market performance in 2017, we continue to believe fixed income plays a vital role in a well-diversified portfolio. Even in a low return, low-yield environment, high-quality bonds serve as an important diversifier, helping to manage risk from equities and other higher risk asset classes. During equity market pullbacks (greater than 5%) since 2010, the S&P 500 averaged a -11% total return, while the broad bond market returned 1.6%, on average [Figure 1]. Although this absolute return is not very exciting, the outperformance relative to equities (+12.6%, on average) demonstrates high-quality fixed income's value as a risk mitigation tool.

Please see our *Outlook 2017: Gauging Market Milestones* publication for insights on the economy, stock and bond markets, and investments for the year ahead. This week's commentary features content from that publication.

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RETURNS LOSING STEAM, NOT BROKEN

Scenario analysis for the broad bond market in 2017 shows the influence that interest rates can have on high-quality fixed income returns [Figure 2]. If Treasury yields are flat it would result in an estimated 3.1% total return. A 0.25% increase in intermediate-term Treasury yields could reduce the total return to an estimated 1.6%, while a 0.25% decrease could boost the broad bond market's total return to 4.5% for the year. We expect the 10-year Treasury yield to end 2017 in its current 2.25–2.75% range, leaving bond prices near flat with the majority of their total returns driven by coupon income. Our bias is toward the upper end of the range, and we do see the potential for the 10-year Treasury yield to end the year as high as 3.0%, should meaningful fiscal stimulus be enacted. Even with that wider range, our total return estimates for the broad bond market range from approximately 0.5% to 4.0%. This drives our expectation for the broad high-quality bond market's "muted" return, relative to the 10-year average total return of 4.6% and 25-year average of 6.3%.

1 **BOND PERFORMANCE RELATIVE TO EQUITIES SHOWS DIVERSIFYING ROLE OF HIGH-QUALITY FIXED INCOME**

Stock Market Peak to Trough*	Duration (~Weeks)	S&P 500 Total Return	Barclays Aggregate Bond Total Return	Difference
12/29/15–2/11/16	6	-11.8%	2.5%	14.3%
8/17/15–9/28/15	6	-10.5%	0.3%	10.8%
9/18/14–10/15/14	4	-7.4%	2.1%	9.5%
5/21/13–6/24/13	5	-5.8%	-3.1%	2.7%
9/14/12–11/14/12	9	-7.5%	1.2%	8.7%
4/2/12–6/1/12	9	-9.9%	2.2%	12.1%
7/7/11–10/3/11	13	-18.8%	4.2%	23.0%
4/23/10–7/2/10	10	-16.0%	3.0%	19.0%
Average:		**-11.0%**	**1.6%**	**12.6%**

Source: LPL Research, Bloomberg, Standard & Poor's, Barclays 11/30/16

*These time periods represent the most recent periods of a greater than 5% pullback (peak to trough) in the S&P 500.

All indexes are unmanaged 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. All performance referenced is historical and is no guarantee of future results.

2 **BROAD BOND MARKET RETURNS MAY BE MUTED IN 2017**

Change in 10-Year Treasury Yield	-0.75%	-0.50%	-0.25%	0.00%	+0.25%	+0.50%	+0.75%
Total Bond Return	7.5%	6.0%	4.5%	3.1%	1.6%	0.2%	-1.3%

Source: LPL Research, Barclays 11/30/16

Scenario analysis is based on a return of 3.1% as of 11/11/16 for the Barclays Aggregate, based upon one-year time horizon, parallel shifts in the yield curve, no change to yield spreads, and no reinvestment of interest income.

This is a hypothetical example and is not representative of any specific situation. Your results will vary. The hypothetical rates of return used do not reflect the deduction of fees and charges inherent to investing.

Indexes are unmanaged and cannot be invested into directly.

The onset of a U.S. recession or a major unexpected shock to the global economy could push rates lower and bond prices higher; however, prices on high-quality fixed income securities are more likely to be under pressure from several major sources in 2017.

- **Fiscal stimulus.** Long-term bond yields compensate investors primarily for the risk of not being invested in higher return opportunities related to economic growth and inflation (which eats away at real returns). The "term premium" in fixed income markets represents the additional compensation that investors demand for holding longer-term bonds relative to shorter-term bonds. If Trump is able to pass fiscal stimulus measures, including tax cuts, through a united Congress, that term premium could continue to rise with the increased prospect of greater growth and higher inflation. This would push long-term yields higher, pressuring bond prices. In addition, at least one top rating agency has warned that should all of Trump's proposed economic and fiscal policies be enacted, it would be negative for U.S. sovereign creditworthiness due to its impact on the deficit, which may also be putting upward pressure on yields.
- **Ongoing Fed rate hikes.** Fed rate hikes will likely push short-term interest rates higher in 2017. Though potentially painful for many fixed income investors, normalization of interest rate policy by the Fed is also a positive milestone for the health of the economy. Raising interest rates further will also give the Fed more tools at their disposal should the economic recovery sputter.
- **Foreign selling.** Foreign countries have been liquidating Treasuries during 2016 at a pace above that seen in recent years. Many foreign nations sell Treasuries to fund international payment obligations or to devalue their currencies in response to liquidity issues, export weakness, or defaults at home. Investors are less apt to hold longer duration Treasuries if they find Trump's tariff proposals credible, due to the possibility of a trade war. Until clarity on U.S. trade policy is provided, we expect more volatility in the Treasury market.
- **Increasing risk premiums due to political uncertainty.** Trump's policies are likely to be pro-business and anti-regulation, but his outsider status and complicated mix of priorities may increase policy uncertainty from the nation's highest office. Investors demand additional compensation in the form of higher yields for the added risk. The more Trump's plans are known and understood by markets, the lower this additional yield compensation may need to be.

SEARCH FOR YIELD ISN'T OVER

High-yield bonds and bank loans could be two potential ways to help some suitable investors increase yield in their fixed income portfolios, in what is still a historically low-rate environment. High-yield returns have been mainly driven by fluctuations in the high-yield energy sector since mid-2014, when the price of oil began its steep decline from $105/barrel to a low of $26 in mid-February 2016. A substantial number of defaults occurred in the energy sector in 2015 and 2016, helping to remove some of the weaker industry players. With oil oscillating in the $40–50 range throughout the majority of 2016, high-yield valuations increased throughout the latter half of the year as default prospects slowly improved. Despite this improvement, the price of oil remains a powerful force in the high-yield market and an ongoing risk.

Amid continued improvement in the price of oil, the theme of improving fundamentals is poised to continue into 2017, as default levels for high-yield bonds are projected to decline from 4.5% at the end of 2016 to roughly 3–3.5% in 2017, based on estimates from credit rating services. While this is good news for the high-yield bond market, much of that improvement is already reflected in current valuations, leaving high-yield with little room for error in the case of equity market weakness or another destabilizing force. Non-financial corporate debt-to-earnings levels, which can indicate how much debt firms in the high-yield market are carrying on a relative basis, continue to increase. This is a negative fundamental trend, on balance, but the limited amount of high-yield debt maturing in 2017 should help support the asset class.

However, we do expect high-yield valuations to richen slightly during 2017, which would support prices, in part due to the prospect of business-friendly policies from a Trump administration. Nevertheless, we believe interest payments will drive the majority of high-yield's return, similar to high-quality fixed income. Given that, we anticipate mid-single-digit returns driven by interest income for high-yield bonds.

BANK ON HIGHER SHORT-TERM RATES

While longer-term Treasury rates are largely driven by expectations of future U.S. economic growth and inflation, short-term Treasury yields are more sensitive to Fed policy. With the prospects of additional Fed rate hikes in 2017, short-term rates are poised to continue to move upward. One potential beneficiary is bank loans, which are similar to high-yield bonds in that they are below investment grade, but different in that they are generally less volatile and have interest payments that fluctuate based on global short-term interest rate benchmarks. Bank loans may represent a similar, but somewhat more conservative option than high-yield bonds for investors who seek yield while simultaneously attempting to manage interest rate risk. Bank loans are also less sensitive to the energy sector, which only represents approximately 3% of the bank loan market, compared to roughly 14% of the high-yield market. Although the yield of bank loans is lower than that of high-yield bonds and the prospects for capital appreciation are more limited, the sector remains a solid option for income for suitable investors who understand their risks, in our view.

MUNICIPAL OUTLOOK

Post-election, as fixed income markets digested the economic implications of a Trump presidency, yields in the tax-sensitive municipal market began to spike, though not as much as Treasury yields. Prices should stabilize relative to Treasuries once the new administration clarifies its tax policy. The overhang of underfunded pension liabilities may drive credit risk up in certain states until they shore up their fiscal positions. If Trump's infrastructure plan necessitates borrowing by states and municipalities, excess supply could also pressure the municipal market in 2017, but this is another area where the impact cannot be fully evaluated until we have greater policy clarity. ■

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.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

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 are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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. These Lower-quality debt securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply.

Because of their narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.

INDEX DEFINITIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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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