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BOND
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PERSPECTIVES

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FINALLY, HIGHER YIELDS IN SHORTER MATURITIES

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KEY TAKEAWAYS

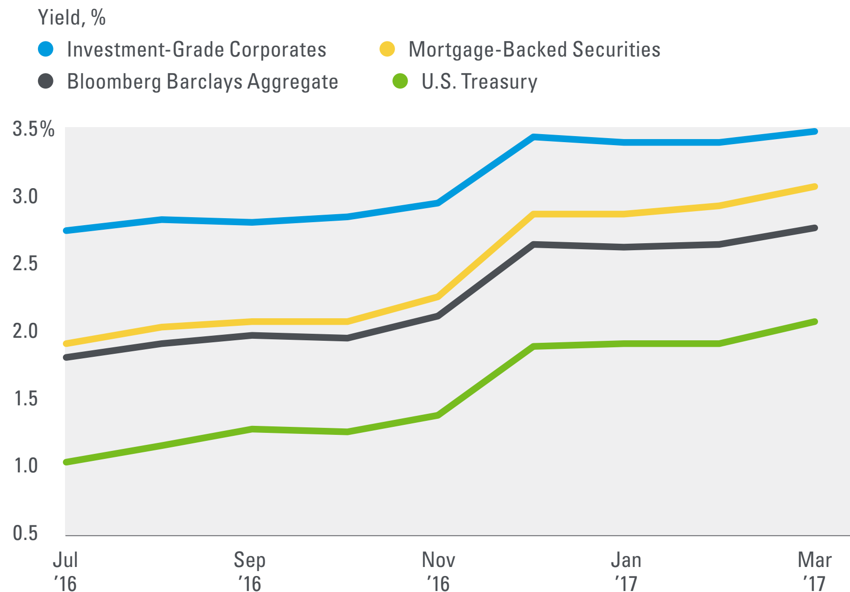
High-quality bonds have cheapened from their low yields in July 2016, offering higher yields in most sectors.

With interest rates on the rise, short-term bonds may represent a better risk/reward relationship for defensive portfolio positioning.

Scenario analysis shows that if rates rise, short-term bonds may outperform intermediate maturities.

With shorter-maturity yields increasing as of late, the front end of the yield curve (shorter-maturity fixed income) may be offering an enticing relationship between risk and reward, and a potential place for investors to play defense. We've heard the adage before that the best defense is a good offense. But with interest rates on the rise, perhaps a good defense would trump a good offense. For the second time in three months, the Federal Reserve (Fed) is poised to raise interest rates (see our recent Weekly Economic Commentary). This has set a negative tone in fixed income markets and left investors wondering if bond prices have bottomed, or if more losses are still to come. Sector selection and yield curve allocation decisions are difficult decisions in rising rate environments, but with scenario analysis, we can begin to determine how portfolios may perform in this challenging market.

1 HIGH-QUALITY FIXED INCOME PRICES HAVE CHEAPENED (YIELDS INCREASED) SINCE JULY 2016



Source: LPL Research, Bloomberg 03/10/17

The Bloomberg 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). It is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

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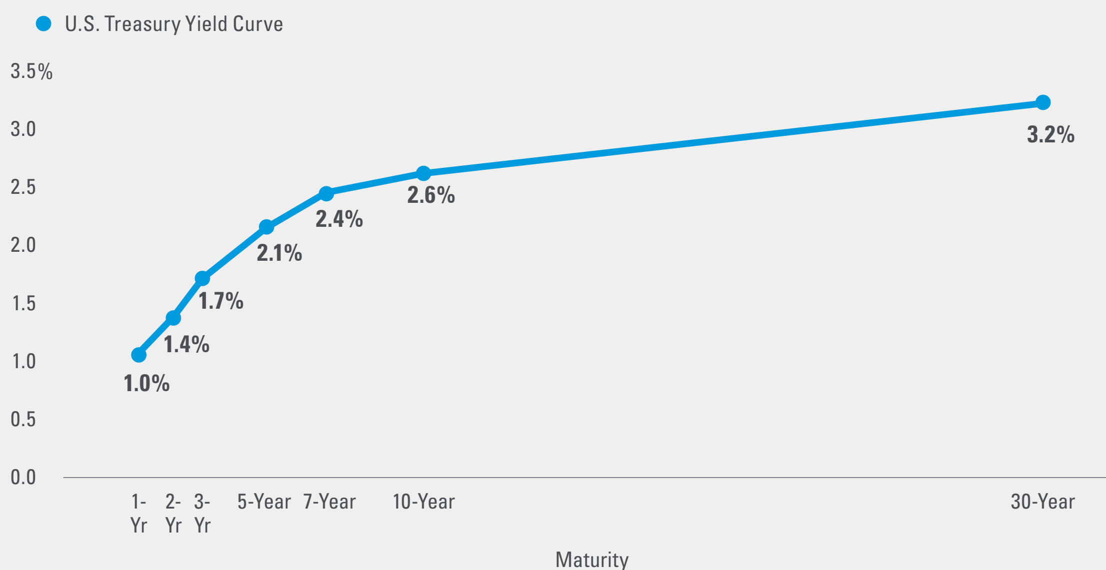
The Bloomberg Barclays Aggregate Bond Index, the most widely used high-quality bond benchmark, serves as a good example of the price weakness that has surfaced in fixed income. The index, which is mostly comprised of Treasury bonds, securitized mortgage-backed securities, and investment-grade corporates, saw yields rise from a low of 1.82% in July 2016, to a high of 2.78% recently [Figure 1]. Cheaper prices, coupled with shorter-maturity yields adjusting more dramatically to the Fed rate hikes, present investors with an opportunity to reduce interest rate sensitivity, while not sacrificing a lot of yield, thus playing defense in this volatile market.

With the focus on Fed rate hikes, and inflation gradually moving higher, conditions have favored risk assets (such as stocks) and been a headwind for fixed income assets since early November, because there is an inverse relationship between bond prices and interest rates. As a result, bonds have been getting cheaper relative to stocks, increasing their attractiveness. For example, the U.S. Treasury 10-year bond yield is now at 2.58%, more than 1.2% higher than its 1.36% low yield last July. This is 65 basis points (0.65%) higher than the estimated S&P 500 dividend yield (2.58% vs. 1.93%), making the 10-year Treasury cheaper than stocks using this metric. The last time this occurred was September 2014 and bond investors who took advantage of the cheaper prices were rewarded as the 10-year Treasury note rallied substantially, with the yield moving from 2.60% to 1.60% over a four-month period (September 17, 2014 to January 30, 2015), during which time the Bloomberg Barclays Aggregate returned 4.3%. Besides the 10-year Treasury bond, other high-quality sectors have cheapened enough to warrant a second look. Up-in-quality bonds like municipals, investment-grade corporates, and mortgage-backed bonds are much cheaper now than last year.

TAKE WHAT THE YIELD CURVE GIVES

Plotting the yields of various maturity bonds generates the "yield curve" [Figure 2]. The yield curve is considered steep when the line is upward sloping, with longer yields substantially higher. A

2 5- TO 30-YEAR MATURITIES OFFER YIELDS ABOVE 2%



Source: LPL Research, Bloomberg 03/10/17

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flat curve occurs when shorter maturities are closer in yield to longer ones, causing little incentive for investors to buy longer-maturity bonds. As Figure 2 reveals, the yield curve is steep out to 10 years, but flattens from 10 to 30 years. The higher yields in shorter maturities make the decision on where to invest on the curve a less difficult one. Investors need not venture out into the most volatile part of the curve (past 20 years) in order to gain more potential return. The longer maturities do not offer enough compensation to take on the additional interest rate risk. Why invest in 30 years at 3.19%, when the 10-year part of the curve is offering 2.61%? The same type of analysis can be made when focusing on five years relative to 10 years. At a 2.14% yield, the five year is at its cheapest level since 2011, and investors only sacrifice 0.47% of yield by staying shorter, relative to the 10-year maturity. Our baseline scenario for the Treasury curve is for higher interest rates without a big flattening move. In this scenario, investors can take what the curve is giving by targeting shorter-duration bonds in the 5–10 year part of the curve. Shorter maturities can also be used for liquidity if the market becomes volatile. Owning a 10-year bond is a lot less risky than a similar quality 30-year bond if interest rates continue to rise.

LET SCENARIO ANALYSIS DECIDE

It is difficult to determine yield curve positioning without a firm opinion on the direction of interest rates. One way to begin to formulate this opinion is to focus on hypothetical return scenarios. By comparing a short-term bond profile versus an intermediate-term profile and stress testing them for interest rate changes, we can see which maturity could potentially perform best [Figure 3]. Our analysis compares total returns for the Bloomberg Barclays 1-3 Year Government Bond Index (shorter-term index comprised of government and corporate bonds) against the Bloomberg Barclays Aggregate Index (intermediate-term index). The analysis demonstrates that when interest rates rise by 0.25%, the short-term index outperforms the longer intermediate index by 0.05%. This advantage increases as interest rates rise.

Note that if the opposite occurs and interest rates decline, the scenario analysis clearly favors intermediate bonds. If interest rates remain stable or even fall by 0.25%, then intermediate bonds outperform short-term bonds by 1.0% in an unchanged scenario and 2.05% in the lower-rate environment. Considering that the Fed is telegraphing at least two additional rate hikes this year, lower rates are less probable and prices have

3 SCENARIO ANALYSIS: SHORT-TERM VS. INTERMEDIATE BONDS

Change in Bond Yields	-1.00%	-0.75%	-0.50%	-0.25%	0.00%	0.25%	0.50%	0.75%	1.00%	1.25%	1.50%
A–Short-Term Bonds	4.03%	3.54%	3.05%	2.55%	2.06%	1.57%	1.08%	0.58%	0.09%	-0.40%	-0.90%
B–Intermediate Bonds	9.22%	7.68%	6.14%	4.60%	3.06%	1.52%	-0.02%	-1.56%	-3.10%	-4.64%	-6.18%
Total Return Difference (A-B)	**-5.19%**	**-4.14%**	**-3.10%**	**-2.05%**	**-1.00%**	**0.05%**	**1.10%**	**2.14%**	**3.19%**	**4.24%**	**5.29%**

Source: LPL Research, Bloomberg 03/13/17

Short-term bonds represented by Bloomberg Barclays 1-3 Year Government/Credit Index, Intermediate bond returns represented by Bloomberg Barclays Aggregate Bond Index.

Scenario analysis is based on a return of 2.06% as of 03/13/17 for the Bloomberg Barclays 1-3 Year Government/Credit Index, and a return of 3.06% as of 03/13/17 for the Bloomberg Barclays Aggregate Bond Index, at no change in interest rates (0.00%). Total returns assume one-year time horizon, parallel shift of the yield curve and no change in yield spreads among non-Treasury sectors.

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.

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come down on short-term bonds, so investors can play it relatively safe in more liquid, short-term bonds without sacrificing much yield.

CONCLUSION

We expect the roller coaster ride in fixed income may continue throughout 2017. Prices have cheapened and the front end of the yield curve has adjusted to the increased volatility driven by the Fed rate hikes and now offers considerable risk/reward benefits. As such, we continue to favor more defensive fixed income curve positioning in the 5- to 10-year part of the curve with neutral- to short-benchmark interest rate sensitivity. Within high-quality fixed income, a diversified allocation to various sectors, including investment-grade corporates and mortgage-backed securities, remains our preferred approach for riding out the volatility of rising interest rates. ■

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

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.

Treasury Inflation-Protected Securities (TIPS) are subject to interest rate risk and opportunity risk. If interest rates rise, the value of your bond on the secondary market will likely fall. In periods of no or low inflation, other investments, including other Treasury bonds, may perform better.

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.

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.

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.

DEFINITIONS

The Bloomberg 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).

Bloomberg Barclays 1-3 Year Government Bond Index is a market value-weighted performance benchmark of investment grade government and corporate bonds with maturities of one to three years. An investment cannot be made directly in an index.

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.

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