LPL RESEARCH

BOND MARKET PERSPECTIVES

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FURTHER FLATTENING

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KEY TAKEAWAYS

The yield curve continues to flatten, but remains far from inverting or signaling an impending recession.

The most recent decline in steepness has been driven by higher expectations for future rate hikes, due to continued economic improvement and a pickup in inflation expectations.

Recent Treasury yield curve flattening may be a warning sign from fixed income markets, but there are also arguments to suggest otherwise. Historically, an inverting yield curve has been a solid leading indicator of recessions. However, the yield curve's recent behavior is seemingly incongruous with that of equity markets, which have continued to hit record highs throughout the year. Although the yield curve may be implying a slower growth environment than equity markets are signaling, the curve is still a long way from inverting.

1 YIELD CURVE HAS GRADUALLY FLATTENED THROUGHOUT 2017

Source: LPL Research, Bloomberg 11/13/17

Performance is historical and no guarantee of future results.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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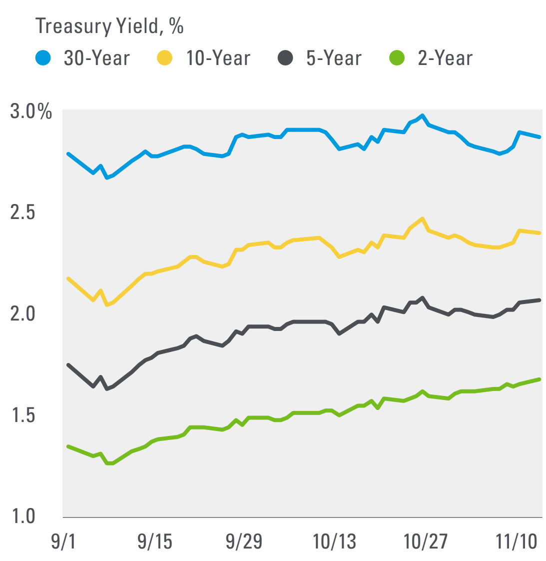
CONTINUED FLATTENING...

Year to date, the Treasury yield curve has flattened considerably. The steepness of the yield curve, the difference between longer- and shorter-term Treasury yields, can be seen as a proxy for future growth and inflation expectations. If a high rate of growth and inflation are expected, fixed income investors will demand more of a premium to lock in their money at prevailing interest rates for a longer period of time. After locally peaking at a steepness of 1.36% on December 22, 2016, the 2-year/10-year curve has flattened considerably to a cycle low of 0.68% on November 7, 2017, below its pre-election level one year ago [Figure 1]. The 5-year/30-year curve has flattened to a similar extent. Despite this seemingly pessimistic indicator from fixed income markets, equity markets have continued to move higher, with the S&P 500 Index up 17.3% on a total return basis year to date through November 10, 2017.

2 SHORT-TERM YIELDS' INCREASE HAS OUTPACED THAT OF LONGER-TERM YIELDS



Source: LPL Research, Bloomberg 11/13/17

Performance is historical and no guarantee of future results.

...BUT FAR FROM INVERTING

Investors must remember that despite the trend of flattening throughout the year, the yield curve is still far from inverting. An inverted yield curve has historically been a good indicator of recessions, and has preceded each of the last nine recessions going back to 1955. On average, an inversion has led the subsequent recession by about five quarters; in the most recent recession in 2008, it was eight quarters. We don't believe that there will be a yield curve inversion during 2018, so despite relative flatness, the yield curve is not signaling an impending recession.

WHY THE STALL?

The most recent leg down in steepness started in the beginning of September. Since then, the yield curve has flattened modestly again, by 10 basis points (0.10%) based on the 2-year/10-year steepness and by 23 basis points (0.23%) based on the 5-year/30-year (as of November 10, 2017). Although a flattening yield curve usually brings to mind rising short-term yields and declining long-term yields, this most recent flattening event has occurred as yields have risen across the entire yield curve, with short-term outpacing long [Figure 2].

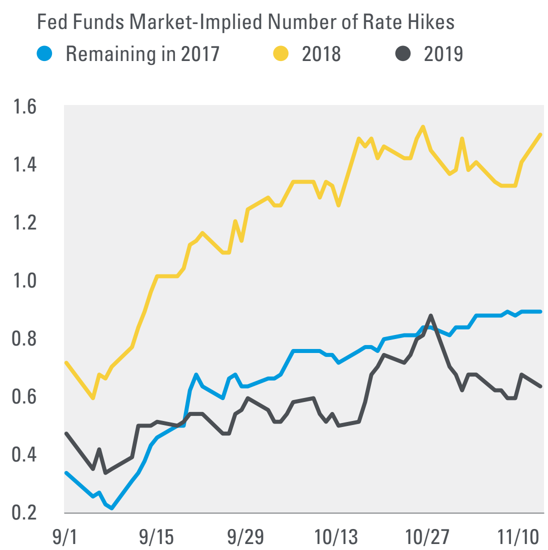
Several factors are contributing to this current environment:

- **Inflation expectations.** Longer-term yields have moved higher since early September, pressured by increasing inflation expectations (the difference between Treasury yields and Treasury Inflation-Protected Securities yields) as the price of oil has continued to rally. Breakeven 10-year inflation expectations moved from 1.78% to start September, to 1.91% as of November 10, 2017.

- **Policy progress.** Further development on potential tax reform has also pushed long-term rates higher, as has ongoing support from economic data.
- **Rate hike expectations.** Rate hike expectations for the next two years have waned as a result of Jerome Powell's nomination to lead the Federal Reserve (Fed), as he is considered less hawkish relative to other candidates who were being considered. However, those expectations have nonetheless climbed considerably since early September [Figure 3].

Although Powell signals continuity of current (relatively dovish) monetary policy from the Fed, rising inflation expectations may force the Fed's hand, potentially leading to a more aggressive pace of rate hikes in coming years. For years, the Fed has found itself in a "goldilocks zone" with decent growth, an improving labor market, and yet tepid inflation, allowing them to pursue a very gradual, measured approach to interest rate hikes. But should labor market tightness lead to a surprise pickup in inflation to the Fed's 2% target (or higher), the Fed could be forced into quick successive hikes. Neither the Fed nor financial markets would like this scenario.

3 RATE HIKE EXPECTATIONS HAVE NOTCHED HIGHER SINCE EARLY SEPTEMBER



Source: LPL Research, Bloomberg 11/13/17

Market-implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate hike expectations may not develop as predicted.

GLOBAL FACTORS

The global nature of the investment landscape may also be partially to blame for our flattening yield curve. Demand for high-quality developed market sovereign debt remains strong, and the U.S. boasts longer-term yields far above those of Germany, Japan, and almost all other developed nations. As we have seen throughout 2017, a material rise in Treasury yields has inexorably been met with a pickup in foreign demand, limiting further upward moves in long-term rates, and thus leading to a flatter curve.

Global central bank action over the last decade could also be changing the efficacy of yield curve inversion as a recession predictor. Through programs like the Fed's quantitative easing, in which bonds were purchased to drive down interest rates (the European Central Bank and Bank of Japan are still employing similar programs), investors have been reaching for yield in a progressively lower-yielding environment. Ten years ago, an investor could get 3.25% yield on a 3-month Treasury bill, whereas today, that investor can only receive 2.88% yield on a 30-year Treasury bond. Investors in search of meaningful yields have been pushed to longer-maturity bonds, keeping the yield curve flat and potentially limiting the importance of the yield curve inversion signal, should we get one.

CONCLUSION

Although the bond market is sending more sobering signals than equity markets, other indicators corroborate the equity market's view of the economy, including: improving economic data, solid gross domestic product growth, positive earnings, and high consumer confidence, among others.

Factors like foreign demand and still benign inflation are helping to restrain the long end of the yield curve, while interest rate hikes (and expectations for future hikes) have picked up steam, leading to a gradually flattening curve. The curve remains far from inverted, however, and is not yet sending a warning signal from the fixed income markets. ■

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.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments, and exports less imports that occur within a defined territory.

Yield curve inversion is a situation where longer-term interest rates fall below shorter-term interest rates.

The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

International debt securities involve 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.

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.

INDEX DEFINITION

The Bloomberg 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).

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