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THE FUTURE IS ALREADY HERE

Anthony Valeri, CFA *Fixed Income & Investment Strategist, LPL Financial*
Colin Allen *Senior Research Analyst, LPL Financial*

KEY TAKEAWAYS

Due to still expensive valuations and low yields, we believe the current low-return environment could potentially persist for high-quality bonds for several years.

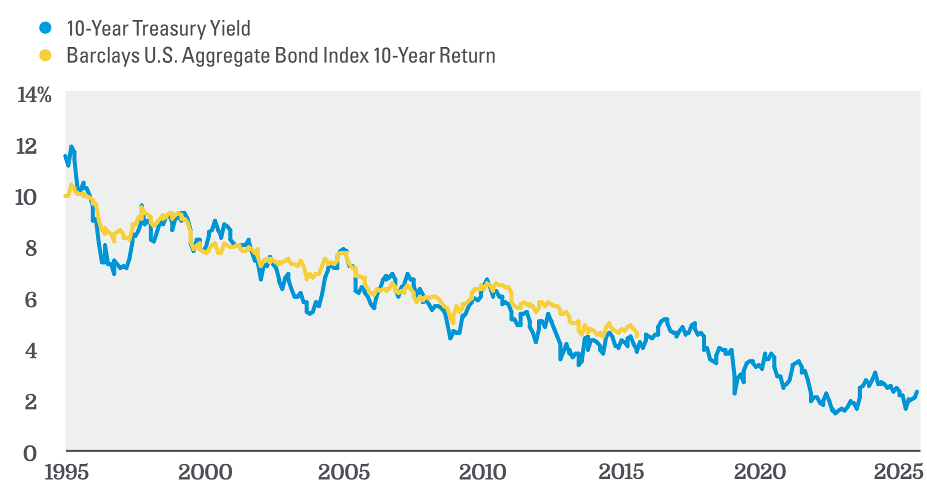
Rising interest rate risk and still declining income generation pose an additional challenge.

A good idea of what the future will look like for bond investors is already here. The three-year average annualized total return of the Barclays Aggregate Bond Index, a broad measure of high-quality bond performance, stood at a very modest 1.8% at the end of June 2015. This is an average return, and shorter-term returns have been both higher and lower over the past three years, but it provides an approximation of what investors may expect over a longer time frame. The trailing five-year annualized total return is 3.1%, which is still low, but illustrates the downward trend of high-quality bond returns over the past few years. The question over what rising interest rates will mean for bond investors may already be answered.

Over long periods of time, yield is an excellent forecaster of future bond market returns [Figure 1]. Shifting the 10-year Treasury yield 10 years into the future shows how closely 10-year annualized returns of high-quality bonds track yields. Over the short term, price movements can have a significant impact on bond performance; however, over the long term, yield is the dominant driver of returns. The trailing 10-year return of the Barclays Aggregate Bond Index is now down to nearly 4%, down from 6% near the end of 2010. Over a 10-year holding period, yield levels reveal a lot about future returns, and the downward trend in bond performance is not likely over.

Figure 1 also illustrates that the current level of the 10-year Treasury yield suggests the total return environment of the past three years could possibly

1 YIELD IS THE DOMINANT DRIVER OF HIGH-QUALITY BOND RETURNS OVER THE LONG TERM



Source: LPL Research, Bloomberg, Barclays 06/30/15 persist for several more years. Low yields have been a characteristic of the bond market for a few years now and help explain the sub-2% annualized returns over the past three years. But these same low yields foreshadow a persistence of the low-return environment.

A BAD COMBINATION

Compounding the low-yield environment is rising interest rate risk. The U.S. Treasury has taken advantage of lower interest rates to issue more long-term debt, relative to short-term debt. Corporate bond issuers have also locked in attractive borrowing costs for longer periods of time, and the overall interest rate sensitivity, or duration, of the broad high-quality bond market has steadily increased in recent years [Figure 2]. Investments that mimic the broad Barclays Aggregate Bond Index may be gradually taking more interest rate risk and subject to more weakness when rates rise.

Figure 2 also contrasts the increase in duration with the decline in yields but specifically reflected by the average interest (coupon) rate to more accurately measure income generation. Not only is interest rate sensitivity of the broad bond market increasing, but investors receive less interest income to offset price declines associated with rising interest rates. Interest income declined as higher interest rate debt matured and was replaced with lower interest rate debt. As lower interest rate debt replaces older, higher coupon rate debt, interest income generation declines. Interest income can help investors play defense in a rising rate environment and boost returns in an environment of stable interest rates, but less income means it takes less of a rise in interest rates to suppress overall bond returns. The ideal environment for a fixed income investor is higher yields with less interest rate risk; but the opposite is happening in markets today—investors are compensated less for the risks taken.

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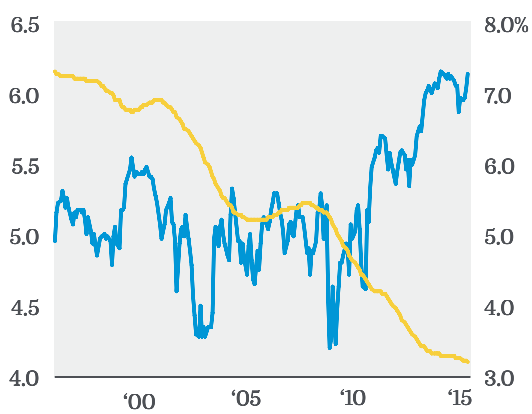
2 BROAD INTEREST RATE SENSITIVITY IS RISING WHILE INTEREST INCOME IS FALLING

Barclays U.S. Aggregate Bond Index

- Average Duration (Years), Left Scale
- Average Coupon Rate, Right Scale



Source: LPL Research, Barclays 06/30/15

CENTRAL BANK INTERVENTION

Central banks in Europe, China, and Japan are adding to the challenge either by lowering interest rates and/or purchasing bonds (via quantitative easing [QE]). Bond purchases have exerted downward pressure on interest rates and continue to facilitate the issuance of lower interest debt and retirement of higher cost debt. These central bank policies can help support bond prices, which, in one way, is helpful for investors, but still fosters the challenge of a low-return environment. In the U.S., the Federal Reserve (Fed) indicates interest rates will rise but timing remains uncertain. In the meantime, the Fed continues to buy mortgage-backed securities and hold on to Treasury positions.

CONCLUSION

Investors have seen this before and the 1950s serves as a precedent. During the 1950s, the 12-month return of high-quality bonds ranged as high as 8%, in response to a recession, and to as low as -4%, in response to strong economic growth and rising interest rates. Over the entire decade, the average return was 1.5% annualized,* as lower yields ultimately led to lower longer-term returns. Back then, the bond market was comprised almost entirely of government bonds; thus, investors have more options at their disposal today, including high-yield bonds and other economically sensitive debt that offers higher yields, to combat rising interest rates or generate additional income. Still, investors looking for a guide as to what the future may bring need not look further than the present. ■

*According to Lipper Intermediate Government Bond Index data.

INDEX DESCRIPTIONS & 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).

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

The coupon rate is the contractual annualized rate of interest a bond will pay based upon the par value of the bond, usually $1,000.

Quantitative easing (QE) refers to the Federal Reserve's (Fed) current and/or past programs whereby the Fed purchases a set amount of Treasury and/or mortgage-backed securities each month from banks. This inserts more money in the economy (known as easing), which is intended to encourage economic growth.

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