LPL RESEARCH

BOND MARKET PERSPECTIVES

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LOWER FOR EVEN LONGER

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KEY TAKEAWAYS

The Fed's "lower for even longer" message should provide support to high-quality bonds but does not alleviate the low-return environment.

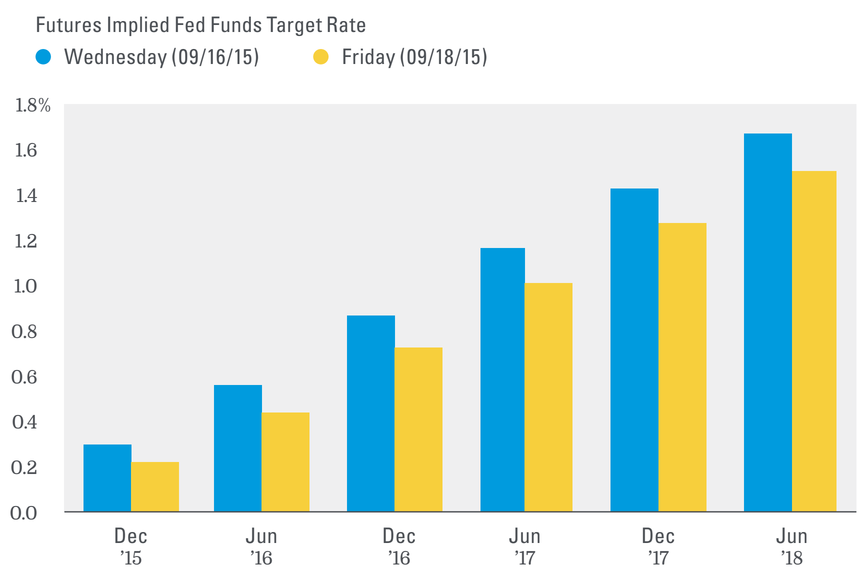
The Fed's hesitancy to raise interest rates should provide a tailwind for lower-rated bonds by facilitating access to credit and continued financing.

The probability of a rate hike by the December 2015 Fed meeting has declined to roughly 30%.

The Federal Reserve (Fed) issued a very dovish message at the conclusion of last week's meeting, with the key message being "lower for even longer." At first glance, the Fed's cautious message was interpreted negatively, with stocks and economically sensitive investments weakening and interest rates falling in response to a weaker global economic outlook, but investors should not get complacent. The Fed downgraded its forecasts for the pace of future economic growth, inflation, and the timing and pace of future interest rate hikes. Fed forecasts showed an approximate 0.25% reduction to overnight borrowing rates in the coming few years. Such sweeping assessment changes are rare.

The adjustment to the Fed meeting was sharp and quick. Treasury yields fell by double-digits across the maturity spectrum before a partial reversal on Monday, September 21, 2015. Futures pricing moved to reflect a later start and slower pace of Fed rate hikes [Figure 1]. The probability of a rate increase by the December 2015 Fed meeting declined to roughly 30%, according to fed fund futures. An interest rate increase by December was priced at 100% for much of 2015, but futures pricing shows how quickly market sentiment has shifted, partially due to the Fed's recent change in tone.

1 MARKET EXPECTATIONS OF FUTURE RATE HIKES FELL SHARPLY



Source: LPL Research, CBOT 09/21/15

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Over the past weekend, three Fed officials expressed their view that a rate hike at one of the two remaining Fed meetings for 2015 remains a real possibility, perhaps trying to massage the Fed's message. Two of these, Richmond Fed President Jeff Lacker and St. Louis Fed President James Bullard, are known to be hawkish-leaning members, but centrist San Francisco Fed President John Williams also stated a rate increase remains on the table. On Monday, Atlanta Fed President Dennis Lockhart, also a centrist, indicated the economy is ready for a rate increase in 2015. We expect that dovish-leaning Fed Chair Janet Yellen and Federal Open Market Committee (FOMC) Vice Chairman Bill Dudley are likely to hold greater influence over Fed policy, but the comments are noteworthy.

Recent comments are a reminder that Fed opinion can change and that a rate hike remains a close call. After all, only two months ago in July, Fed officials made no mention of China and overseas events, yet this was a notable focus in the Fed's statement and press conference. An improvement in overseas economic data, stabilization in commodity prices, or U.S. dollar weakness could change the Fed's opinion — especially if U.S. economic data strengthen.

STILL EXPENSIVE

Bond market reaction on Monday, September 21, 2015, was also a reminder that expensive valuations may give investors pause. Inflation-adjusted, or real, Treasury yields declined throughout the summer before a modest increase in September. The post-Fed meeting move pushed valuations into more expensive territory [Figure 2] and may have prompted selling after last week's late surge. A 10-year real yield below 0.3% has not been sustained since the early part of 2015. The 10-year average 10-year real yield is 1.25%, so the past year's range is indicative of an expensive valuation (the lower the real yield, the more expensive the valuation and vice versa). Within the context of the past year, bond investors have shown resistance to sustaining the most expensive valuations absent proof of a domestic economic slowdown.

2 MORE EXPENSIVE VALUATIONS PROVIDE RESISTANCE AGAINST FURTHER GAINS

Source: LPL Research, Bloomberg 09/21/15

On balance, fewer potential interest rate increases reduce interest rate risk and provide a modest tailwind for bond investors. Although high-quality bond valuations remain expensive, the Fed's cautious stance will help support intermediate- and long-term bond prices. And with market inflation expectations still near post-recession lows, even after Monday's sell-off, investors need more convincing from the global economy before high-quality bond yields move higher. A new trading environment may develop as the tug-of-war between Fed caution and expensive valuations keeps bond yields in a range. The stalemate may have to be determined by global economic data.

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High-yield bond prices have not benefited from the Fed's cautious tone; but at the margin, the longer the Fed refrains from raising rates, the longer companies can continue to access attractive financing and refinancing for higher interest bearing debt. We would suggest investors to not be lulled into the Fed's caution and remain defensive until more attractive opportunities develop. ■

INDEX DESCRIPTIONS

The Standard & Poor's 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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