LPL RESEARCH

BOND MARKET PERSPECTIVES

November 15 2016

MORE THAN JUST A TRUMP TAPER?

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KEY TAKEAWAYS

Last week's Treasury sell-off is broadly being attributed to President-elect Donald Trump's victory, and corresponding increases in policy uncertainty and expectations for higher deficit spending.

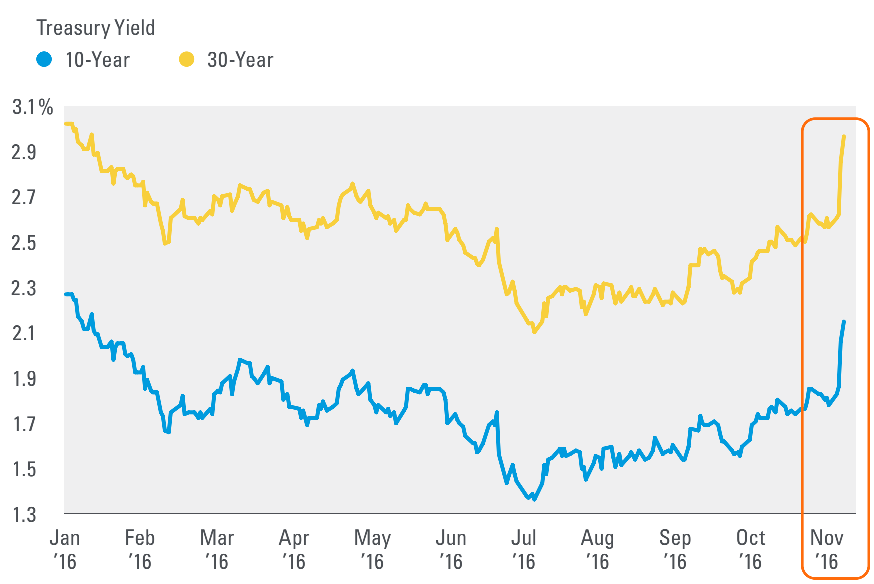
While the Trump effect is at least partly to blame, other drivers including new supply, potential foreign selling, and the ever-present Fed, helped create the perfect storm for bonds.

Sell-offs of this magnitude are rare, which increases the potential of an eventual reversal, though the timing is uncertain.

By now, we've all heard the terms Trumpnado, Trump Taper, and Trexit. These are just some of the names being used to describe the massive sell-off of the U.S. Treasury market that occurred last week. The 10-year Treasury yield ended the week 0.34% higher at 2.15%. Given the low absolute level of yields, the move ranked as the largest gain on a percentage basis (21.1%) going back to at least 1962. The 30-year bond didn't fare any better, moving from a 2.60% to a 2.94% yield [Figure 1]. Sell-offs of this size are rare, suggesting the potential for at least some kind of reversion to the mean rally, possibly once more certainty around President-elect Trump's policies emerges.

Although the election was almost certainly responsible for a good portion of the move, we believe these losses have resulted from more than just policy uncertainty surrounding the new president-elect. New supply to the market, foreign participants selling, and the ever-present Federal Reserve (Fed) have all combined at once, creating the perfect bond storm.

1 10- AND 30-YEAR TREASURY YIELDS SAW SHARP INCREASES FOLLOWING THE ELECTION



Source: LPL Research, FactSet 11/15/16

Performance is historical and no guarantee of future results.

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THEORIES ABOUND

When considering the Trump effect, we first must look back on election night. Heading into Tuesday, November 8, 2016, consensus was that the bond market would react in a Brexit-like fashion, flocking to the relative safety of U.S. bonds* in case Trump pulled off the surprise victory. By 9 p.m. ET on election night, the markets were setting up for this very event. Dow futures were down more than 800 points at their low, and bonds rallied as expected. As midnight approached, the markets had flipped direction, sending Dow futures higher and bond prices spiraling downward.

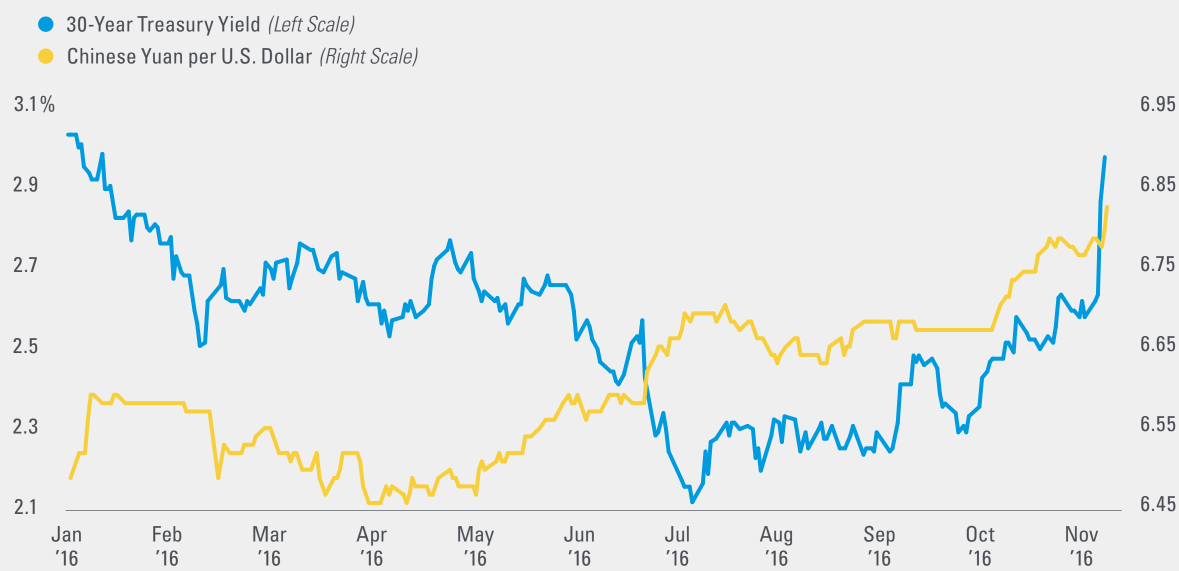
Market corrections of this magnitude typically take much longer than three hours to occur, but this was different. Several theories have been suggested, including that the flip was the result of shock and uncertainty associated with Trump's policies. Another says that in anticipation of higher growth associated with the Trump stimulus spending plan, bond sellers looked to profit by reducing exposure to assets that have rallied this year (such as Treasuries) and reallocated to equities. Bond sellers could also have been reducing holdings because of Trump's statements related to trade wars and protectionism, or concerns around projected increases in the deficit and overall debt levels. Although the election almost certainly had a large impact, the magnitude of the move may suggest that multiple factors were at play.

SUPPLY HEADWINDS

A 10-year bond auction of $23 billion on the day after the election, when the market was still digesting a Trump victory, added a supply headwind to an already unsteady market. The auction was weak, pricing above 2% for the first time since January 2016. The bid-to-cover ratio, considered an indicator of the demand for an auction, came in at 2.22, the lowest since 2009, an indication of a sharp dropoff in investor demand at the auction. The supply

*U.S. Treasuries may be considered "safe" investments but do carry some degree of risk including interest rate, credit and market risk.

2 TREASURY YIELD MOVING LOWER ALONG WITH CHINA'S CURRENCY MAY INDICATE FOREIGN SELLING



Source: LPL Research, FactSet 11/10/16

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picture worsened the next day, with the auction of $15 billion of 30-year bonds. Results were equally poor with coverage of a 2.11, to a yield of 2.90%, higher by 43 basis points (0.43%) from October 2016's auction. Foreign demand for the 10- and 30-year auctions were at their weakest levels since January and August 2015, respectively, with primary dealers absorbing the added supply. As a reminder, foreign owners hold approiximately 45% of Treasuries (based on overall debt of approximately $14 trillion held by the public) and have taken down an average of 64% and 61% of 10- and 30-year auctions year-to-date.

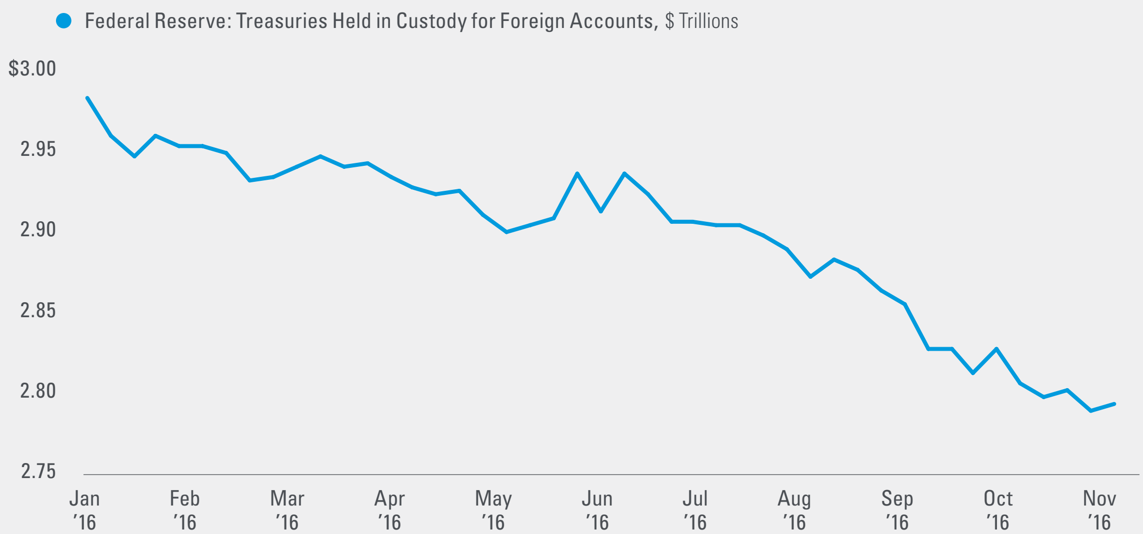
FOREIGN SELLING?

Another factor to consider when looking at market shifts is foreign selling. On November 11, 2016, the People's Bank of China set the trading midpoint value of the yuan at 6.8115 per U.S. dollar, making Chinese exports more competitive. We won't know for sure if China was selling until we receive the Treasury International Capital (TIC) System data two months from now, but Figure 2 seems to indicate that in recent months at least, as the yuan has weakened versus the U.S. dollar [yellow line] and U.S. Treasury bond yields [blue line] have increased, China is selling Treasuries in order to support its currency.

The Federal Reserve Bank of New York releases more timely data on securities held in custody for foreign nations, and these data show that foreign nations have been net sellers of Treasuries since March 2016 [Figure 3]. Year to date, securities held in custody by the Fed for foreign accounts are down more than 6%. Much of this selling was driven by international liquidity issues, along with export weakness and defaults at home, causing them to sell U.S. Treasuries to fund outflows or devalue their own currencies.

Speculation is that countries may be less willing to hold longer duration U.S. debt with Trump threatening tariffs. However, yields are also much more attractive than they were a week ago, and it remains to be seen if the higher yields will entice these buyers back into the market. Until U.S. policy

3 FOREIGN HOLDERS OF TREASURIES HAVE BEEN NET SELLERS YEAR-TO-DATE



Source: LPL Research, Federal Reserve 11/11/16

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clarity is provided, expect more volatility in the foreign exchange markets, U.S. Treasuries, and the U.S. equity market.

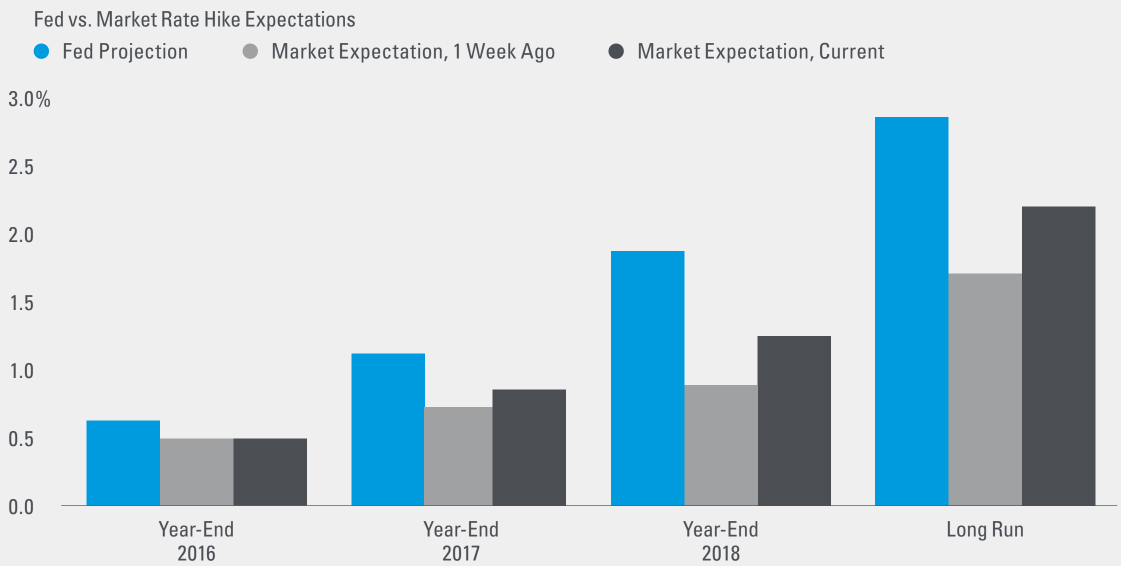
THE FED

On numerous occasions, the Fed has stated that economic conditions warrant raising interest rates at the December 2016 meeting. Prior to the election, the fed funds futures contract, which reflect the market's expectations for a future Fed rate hike, was pricing in an 80% probability of a hike. After Trump's victory, the probability of a December hike moved to over 90%, demonstrating a consensus view that the Fed is still on course to raise rates in December. Longer-term expectations have risen even more, as markets price in more growth and inflation [Figure 4]. Implied inflation expectations, as measured by the difference between the 10-year Treasury yield and the 10-year TIPS (which have semiannual principal adjustments based on headline Consumer Price Index [CPI]) yield, have increased to 1.99% from 1.68% before the election, potentially giving the Fed more ammunition in its case for a rate hike.

CONCLUSION

When considering these factors, it is clear that the market sell-off was more than just the so-called Trump effect. Expectations for larger deficits may require the U.S. Treasury to issue more debt, and this increased supply could push yields higher. We will also be watching for official data on foreign selling, and we continue to believe the Fed is on track to raise rates at its December meeting. All of this, combined with the extreme nature of the recent sell-off, which raises the possibility of an eventual move in the opposite direction, point toward the potential for more volatility. It will take time for markets to decipher the intentions of the incoming Trump Administration, but these other factors will continue to influence the markets in the meantime. ■

4 RATE HIKE EXPECTATIONS HAVE INCREASED OVER PAST WEEK



Source: LPL Research, Bloomberg 11/11/16

Market implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts.

The rate hike expectations set forth in this chart may not develop as predicted.

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) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI), while providing a real rate of return guaranteed by the U.S. government.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

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