LPL RESEARCH

BOND MARKET PERSPECTIVES

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# TECHNICAL FACTORS

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## KEY TAKEAWAYS

Technical factors may conspire to continue the downward pressure on longer-term yields seen since mid-December 2016.

Levels of shorts in Treasury futures markets indicate extreme bearishness, which has historically preceded declines in interest rates.

Despite the possibility of short-term downward pressure on rates from these factors, we maintain our 2017 outlook of gradually rising rates, and long-term investors should consider maintaining a defensive fixed income positioning.

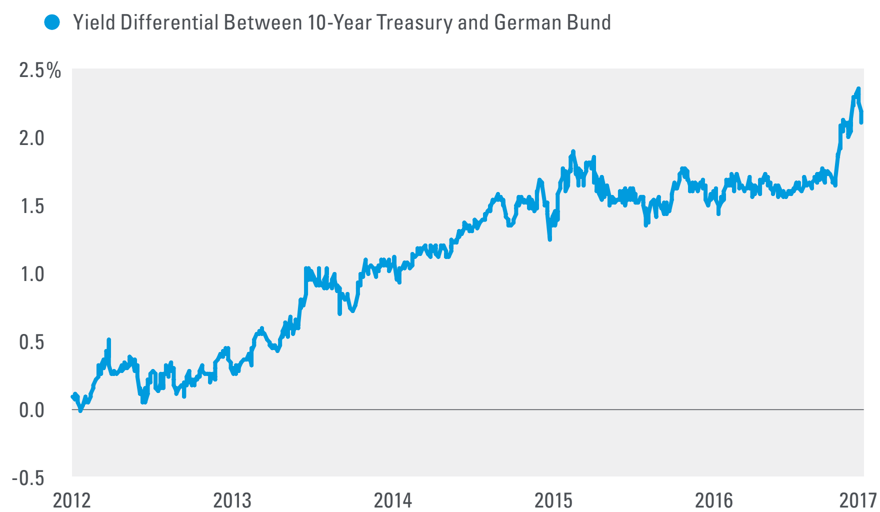
**Although we expect fundamentals to pressure yields gradually higher in 2017, short-term technical and positioning factors may lead yields downward in the near term.** These factors may extend the current momentum in rates markets. Though yields are still elevated from pre-U.S. election levels, fixed income markets have had some reprieve since mid-December, with the 10-year Treasury yield declining from a high of 2.60% on December 15, 2016, to 2.37% as of January 9, 2017.

## LOOKING FORWARD

Low global rates may continue to put downward pressure on U.S. Treasury yields. The yield advantage of the 10-year Treasury to the 10-year German bund now stands at 2.09% (as of January 9, 2017), well above the 10-year average of 0.6% and the 5-year average of 1.1% [Figure 1]. A greater yield advantage of Treasuries, in excess of hedging costs for currency fluctuations, can bring foreign investors back into the Treasury market, as the global search for yield continues.

In fact, that yield advantage appears to be enticing foreign participants back into Treasuries, evidenced by Treasury auction data. In the December 28, 2016 auction of 5-year Treasury bills, indirect bidders, which include foreign central banks, took down 71% of the offering, the highest level on record (data back to mid-2003).

**1 THOUGH OFF PEAK LEVELS, TREASURY YIELD ADVANTAGE TO GERMAN BUNDS REMAINS SIGNIFICANT**



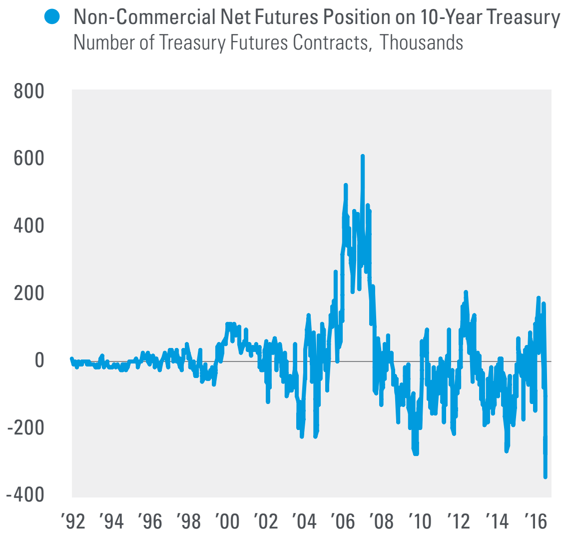

Source: LPL Research, Bloomberg 01/09/17

Performance shown is historical and no guarantee of future results.

# TECHNICAL FACTORS

Additionally, technical issues have become prevalent, with market participants setting up elevated short positions in the futures market

**2 SOME MARKET PARTICIPANTS ARE SHORTER THAN EVER**




Source: LPL Research, Bloomberg, Commodity Futures Trading Commission 01/03/17

(i.e., a belief that the yields will move higher), with fixed-income sentiment becoming extremely bearish. The level of short positions, by one metric, is now the highest level ever recorded (data going back to 1991). Generally, when sentiment is this negative, positive news (for Treasuries) can lead to demand outweighing supply, which can drive Treasury yields lower.

That has been the case historically as well. The shorts on the 10-year Treasury bond, by one measure, currently stand at -344k contracts (as of January 3, 2017) [Figure 2]. This reading has never fallen below -300k, but looking at instances where it has fallen below -200k can help us gauge the downward pressure on yields, should these short positions get squeezed into purchasing Treasuries to cover.

When the level of shorts in the market has reached -200k, the 10-year Treasury yield has on average declined by 0.50% over the subsequent three months [Figure 3].

Although the trends following extreme short positions in the market are clearly for downward

**3 AGGREGATE SHORT POSITIONS OF SIGNIFICANT MAGNITUDE HISTORICALLY LED TO DECLINE IN YIELDS**

| | Forward Change in 10-Year Treasury Yield | | |
|---|---|---|---|
| **Date*** | **One Month** | **Three Months** | **Six Months** |
| 12/31/2014 | -0.51% | -0.26% | 0.21% |
| 4/10/2012 | -0.15% | -0.47% | -0.31% |
| 3/31/2010 | -0.14% | -0.88% | -1.32% |
| 3/31/2005 | -0.32% | -0.43% | -0.10% |
| 6/30/2004 | -0.13% | -0.46% | -0.36% |
| **Average** | **-0.25%** | **-0.50%** | **-0.38%** |
| **Median** | **-0.15%** | **-0.46%** | **-0.31%** |

Source: LPL Research, Bloomberg 01/09/17

*From periods of less than -200k net short level.

Data are from 01/01/1991 – 01/03/2017.

Performance shown is historical and no guarantee of future results

Short selling (also known as shorting or going short) is the practice of selling assets, usually securities, that have been borrowed from a third party (usually a broker) with the intention of buying identical assets back at a later date to return to the lender. The short seller hopes to profit from a decline in the price of the assets between the sale and the repurchase, as the seller will pay less to buy the assets than the seller received on selling them.

pressure on yields, it is important to remember two points:

1. The bull market in bonds, which has lasted approximately 30 years, has been one in which yields have generally declined. Therefore, it is not surprising that yields declined over subsequent periods, despite short positioning in the market. The magnitude and consistency of the subsequent downward moves is still notable.
2. Despite the short-term pressure on yields that technical factors may apply to the market, we still expect longer-term upward pressure on Treasury yields due to gradually rising inflation, pro-business policies from President-elect Donald Trump and additional pressure from two, or potentially three Federal Reserve (Fed) rate hikes in 2017. For more on our forecasts, please see *Outlook 2017: Gauging Market Milestones.*

## PRICING: ANOTHER MEANINGFUL TECHNICAL INDICATOR

Another meaningful technical factor is pricing within Treasury market futures contracts. Many market participants, including technical and algorithmic traders, rely on these markets for access to Treasuries. Since the 10-year hit its local high of 2.60% on December 15, 2016, the price of the 10-year Treasury futures contract has gradually increased, as the yield has declined to its current level of 2.37% (as of January 9, 2017). Moving averages can be meaningful indicators of technical trends. The 10-year Treasury yield has traded above its 50-day moving average since mid-September 2016, but it may break below, should yields continue to decline [Figure 4]. If the 50-day moving average is broken, trend following market participants may buy on that signal, putting further downward pressure on yields.

Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors. A futures contract is a legal agreement, generally made on the trading floor of a futures exchange, to buy or sell a particular commodity or financial instrument at a predetermined price at a specified time in the future.

**4 10-YEAR TREASURY YIELD APPROACHING MEANINGFUL TECHNICAL LEVEL**


Source: LPL Research, Bloomberg 01/09/17

Performance shown is historical and no guarantee of future results.

## CONCLUSION

Despite the potential for short-term downward pressure on yields from technical factors, we anticipate Treasury yields will move gradually, and marginally, higher in 2017, leading to muted fixed-income returns in 2017. High-yield corporate bonds offer potential for additional yield to help protect investors from higher rates, and bank loans with their shorter duration profile may outperform as rates move higher. With less credit risk than high-yield corporate bonds, on average, bank loans offer a diversifying option with less duration risk. Credit risk exists, however, and potential equity market weakness may hurt these sectors while high-quality fixed income may protect investors in similar circumstances. We continue to favor more defensive fixed-income sectors, with slightly below benchmark duration, to manage risk exposure in portfolios from gradually rising interest rates. ■



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