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# RANGE-BOUND RATES

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## KEY TAKEAWAYS

Fixed income markets have been unusually complacent as of late, with some volatility measures still near all-time lows.

Futures market positioning may be contributing to the stickiness in rates over the last several months.

While rates have been range bound, many drivers could push rates higher or lower.

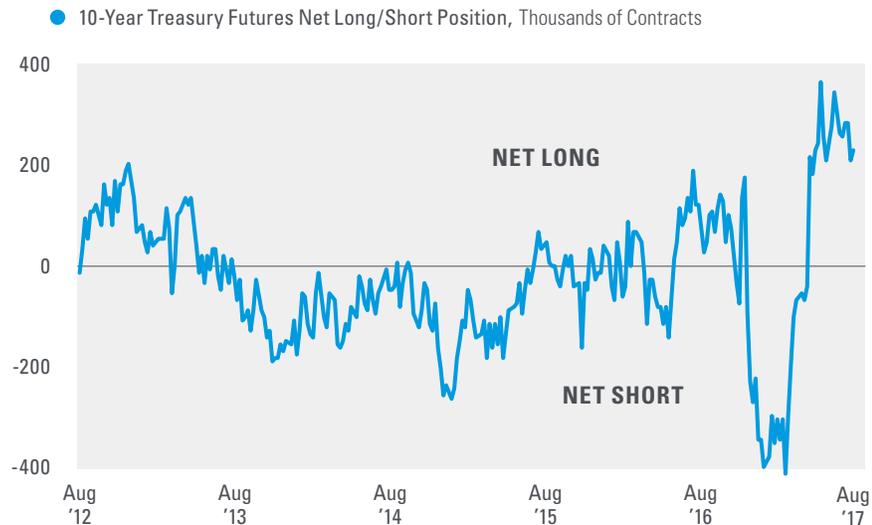
Longer-term interest rates have traded sideways for the last four months, as rate markets search for direction in a complicated market backdrop.

That sideways range has also been tight, as the 10-year Treasury yield has traded within a 32 basis point (0.32%) range for over 90 trading days, the tightest 90-day range in over 45 years. Positioning within futures markets, central bank indecision, and geopolitics have all contributed to rates sticking to their recent range over the last few months.

## TREASURY FUTURES POSITIONING

Beginning in late April, a large net long position amassed in the Treasury futures market. As rates have traded largely sideways since then, these trades have not paid off yet (rates have not moved lower) and traders have not closed them out. Just as importantly, rates have not moved significantly higher, which would squeeze investors out of those positions [Figure 1]. Bottom line, rates will stay

### 1 TREASURY FUTURES MARKET MAY BE RESTRAINING RATES



Source: LPL Research, Bloomberg, Commodity Futures Trading Commission 08/17/17

Past performance is no guarantee of future results.

Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors.

in this range until a catalyst emerges that can push them out of it, at which time futures traders would have a reason to liquidate their positions.

## MOVE VS. VIX

Much has been made of the low volatility in equity markets, with the Chicago Board Options Exchange Volatility Index (VIX) showing a near all-time low reading in late July 2017. Bond markets have been complacent as well, with the bond market equivalent of the VIX, the Merrill Lynch Option Volatility Estimate Index (MOVE), also hitting an all-time low in early August. North Korea-related tensions caused a dramatic rise in the VIX two weeks ago, but bond market volatility remained restrained, evidenced by a marginal pickup in the MOVE relative to the VIX [Figure 2]. Record-low volatility in fixed income markets could be another sign of a market in search of direction—either from central banks or economic indicators pointing to a pickup or slowdown in business or consumer activity.

## CENTRAL BANK LIMBO

With inflation stubbornly unable to reach the Federal Reserve's (Fed) 2% target as of yet, some market participants view the Fed as potentially becoming more dovish in the near future, after raising rates three times between December 2016 and June 2017. Concerns about weaker inflation were confirmed in the Fed's July meeting minutes, which showcased some internal division about hiking rates in the face of low inflation. Although this debate is not new, it certainly has heightened implications as the Fed tries to normalize interest rates while simultaneously reducing its balance sheet from unprecedented levels.

Fed funds futures markets are confirming market expectations of a slowdown in the pace of rate hikes. Based on implied rates from fed futures contracts, the market is not fully pricing in a rate hike for 2018 or 2019, despite the Fed indicating three hikes for each year. This kind of disconnect is not new, as the market has been essentially calling the Fed's bluff over the last few years.

Fed Funds Futures are a product offered by the Chicago Board of Trade which allow investors to speculate on what the Federal Reserve will do with interest rates.

### 2 BOND MARKET VOLATILITY REMAINS SUBDUED, EVEN AS EQUITY VOLATILITY SPIKES



Source: LPL Research, Bloomberg 08/17/17

The MOVE and VIX are unmanaged indexes which cannot be invested into directly. Past performance is no guarantee of future results.

The minutes from the European Central Bank's (ECB) most recent meeting also showed dovishness, on balance, as market participants await further details about when the ECB will taper its bond purchases. We may get more information on Fed Chair Janet Yellen's and ECB President Mario Draghi's views on the stubbornly low inflation this week at their conference in [Jackson Hole, Wyoming](#).

## SHOULD RATES BE HIGHER?

Despite the lackluster inflation readings, there is evidence that the economy has been picking up steam, supporting the argument that rates should be higher. The ratio of the price of copper relative to gold compared to the 10-year Treasury yield seems to back up that assertion.

The rationale behind this comparison is that the price of copper is a harbinger of global economic strength.

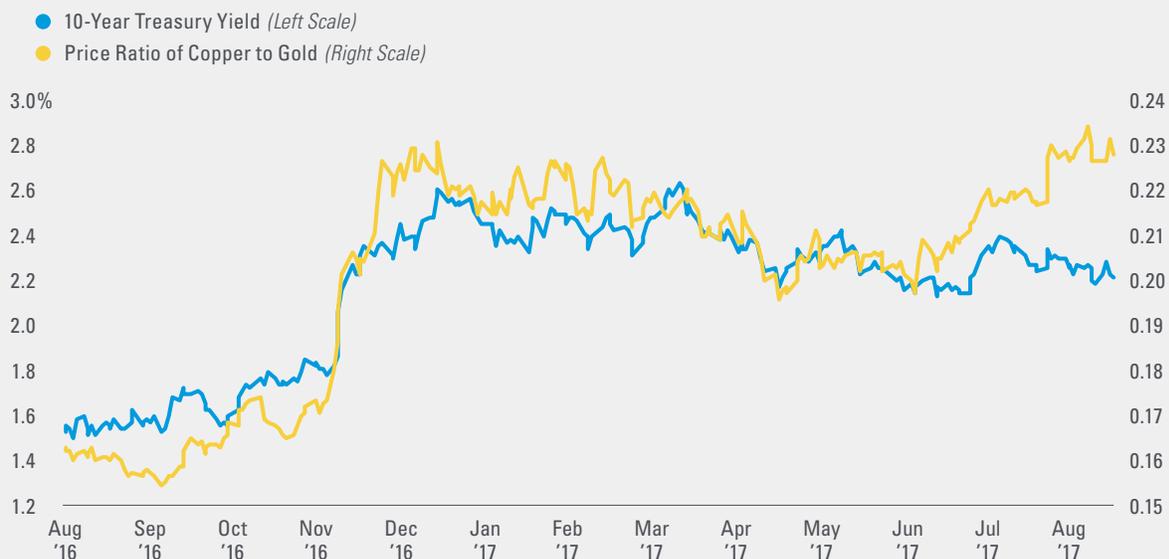
Because copper is a key input in infrastructure projects, it is considered to be a useful indicator of global and U.S. economic health. Generally, when copper prices rise, the economy is expanding, which, historically, has often led to higher inflation, and thus lowers the demand for safe-haven assets such as gold and Treasury bonds.\* In comparing this ratio relative to the 10-year Treasury yield, the two have tended to move together; however, a recent pickup in the copper-to-gold ratio suggests that the 10-year yield is lower than it should be [\[Figure 3\]](#).

## CONCLUSION

Rates have been complacent lately, with longer-term rates trading sideways in a tight range for several months. Given this positioning in the futures market, sharp moves higher in longer-term yields may squeeze traders out of positions, exacerbating an upward move in rates. However,

\*U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit and market risk. They 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. There is no guarantee that gold will maintain its value or purchasing power in the future. Gold investments are not appropriate for every investor.

### 3 COPPER-TO-GOLD RATIO IMPLIES RATES ARE TOO LOW



Source: LPL Research, Bloomberg 08/17/17

Performance is historical and no guarantee of future results.

resurgence in geopolitical concerns, weaker growth, more low inflation readings, equity market weakness, or dovish central bank activity could keep rates restrained or even push them lower. We

still anticipate a gradual increase in rates for the remainder of the year and our 2.25–2.75% year-end target for the 10-year Treasury remains intact.\* ■

\*Scenario analysis based on this potential interest rate range and the duration of the index indicates low- to mid-single-digit returns for the Bloomberg Barclays Aggregate Bond Index.

#### 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.

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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.

Futures and forward trading is speculative, includes a high degree of risk, and may not be suitable for all investors.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

The price of gold can be affected by developments such as currency devaluations or revaluations, central bank movements, economic and social conditions within a country, trade imbalances, or trade or currency restrictions between countries. There is no guarantee that gold will maintain its value or purchasing power in the future. Gold and other speculative investments are not appropriate for every investor.

#### INDEX DEFINITIONS

The Chicago Board Options Exchange Volatility Index (VIX) is a measure of the volatility implied in the prices of options contracts for the S&P 500. It is a market-based estimate of future volatility. When sentiment reaches one extreme or the other, the market typically reverses course. While this is not necessarily predictive it does measure the current degree of fear present in the stock market.

The Merrill Lynch Option Volatility Estimate (MOVE) Index is a yield curve weighted index of the normalized implied volatility on 1-month Treasury options which are weighted on the 2, 5, 10, and 30 year contracts.

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