LPL RESEARCH

BOND MARKET PERSPECTIVES

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INVESTMENT-GRADE CORPORATES: IS THE WORST BEHIND US?

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KEY TAKEAWAYS

Investment-grade (IG) corporate bonds have been the worst-performing high-quality bond segment year to date.

A combination of higher rates, elevated interest rate sensitivity, and changing supply/demand dynamics have contributed to this weakness.

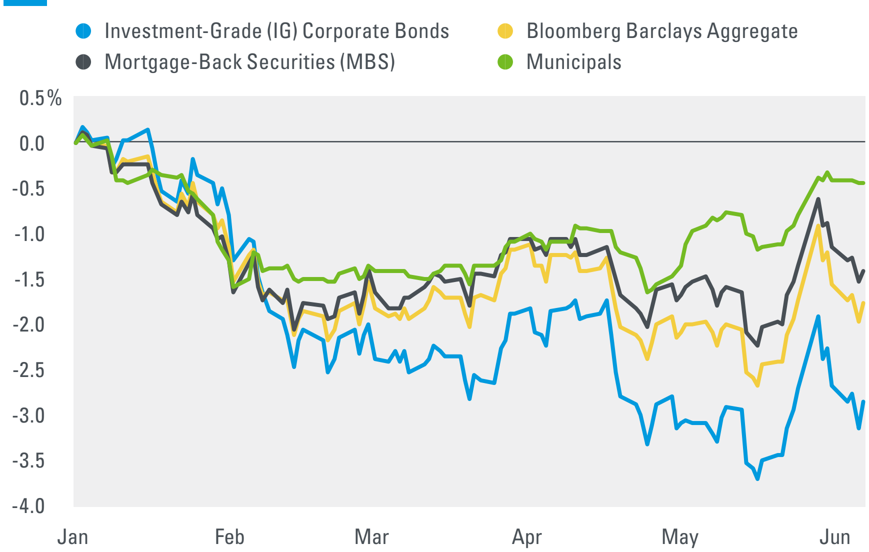
Despite a tough first five months of the year, we anticipate the remainder of 2018 may be more pleasant for investors.

A combination of higher interest rate sensitivity amid rising rates and negative supply/demand dynamics have weighed on investment-grade (IG) corporate bonds year to date, but the remainder of the year may be more pleasant for investors. IG corporate bonds have been the worst-performing domestic segment of fixed income so far in 2018, lagging Treasuries, mortgage-backed securities, and the broad high-quality fixed income market overall [Figure 1].

MIX OF HEADWINDS

With interest rates rising meaningfully this year, IG corporates have been under pressure since the group possesses the most interest rate sensitivity of any segment of the Bloomberg Barclays U.S. Aggregate Bond Index. Consequently, the rise in rates

1 IG CORPORATES HAVE LAGGED OTHER HIGH-QUALITY BOND SEGMENTS



Source: LPL Research, Bloomberg 06/07/18

Performance shown above reflects the total return of the following indexes: Bloomberg Barclays U.S. Corporate Index, Bloomberg Barclays Municipal Bond Index, Bloomberg Barclays U.S. MBS Index, Bloomberg Barclays U.S. Aggregate Index.

Indexes are unmanaged index and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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has been a pronounced headwind for the asset class. Beyond that, changing supply/demand dynamics are also having an impact. Issuance is down relative to last year's record-setting level; but not by as much as investors anticipated so although lower thus far in 2018, supply remains robust.

The makeup of issuers is changing, however, partly due to changes in U.S. tax law and repatriation of offshore profits, especially by tech companies. Tech issuance is down significantly from last year, as tech firms are using their repatriated cash for liquidity, rather than tapping debt markets. Despite supply remaining elevated, the decline from last year should still be providing a tailwind for the market, all else equal, but there is evidence that demand has fallen as well. Lower corporate tax rates have lessened the need for companies to purchase corporate debt, leading to supply/demand dynamics that are contributing to weakness in the market, in addition to the headwind of rising rates. Now the market has at least partially acclimated to this new dynamic, the remainder of the year could be more positive for IG corporates.

A FEW BRIGHT SPOTS

Despite the headwinds for IG corporates year to date, there were relative bright spots, one of which was the differentiation in performance based on maturity buckets. Shorter-maturity IG corporates fared much better amid the rise in rates [Figure 2]. Our preferred segment of the yield curve is intermediate maturities, approximately 5–10 years. At this level, investors aren't taking on uncompensated interest rate risk like they are at longer maturities, yet they're maintaining the potential diversification benefits of high-quality fixed income that aren't normally associated with very short maturities. We still advise suitable corporate bond investors to either target the intermediate portion of the yield curve directly, or leverage an active manager that can help navigate the rising rate backdrop to potentially position the portfolio defensively.

Also shown in Figure 2, shorter maturity bonds can offer an enticing risk/reward tradeoff for investors looking to play defense in a still broadly rising rate environment or those looking for a landing spot

2 SHORTER-DURATION INVESTMENT-GRADE (IG) CORPORATES FARED MUCH BETTER YEAR TO DATE

Maturity Bucket	Duration*	Year-to-Date Return	Yield	Yield/Duration
1–3 Year	2.0	0.0%	3.1%	1.6%
3–5 Year	3.7	-1.3%	3.6%	1.0%
5–7 Year	5.3	-2.3%	3.9%	0.7%
7–10 Year	7.1	-3.6%	4.2%	0.6%
10+ Year	13.7	-6.5%	4.7%	0.3%

Source: LPL Research, Bloomberg 06/07/18

Maturity buckets shown are portions of the Bloomberg Barclays U.S. Corporate Index.

*Duration represents the degree of interest rate risk.

Duration is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates. It is expressed as a number of years. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

Bloomberg Barclays U.S. Corporate Index is an unmanaged index which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

for excess cash. The yield of the 1–3 year maturity bucket (based on the Bloomberg Barclays U.S. Corporate 1–3 Year Index) is the highest it has been since late 2009. That segment also offers the highest amount of yield per unit of interest rate risk (shown in the figure as "duration").

CREDIT WARNING SIGN?

Evidence suggests that negative performance year to date has been mostly driven by rising interest rates, but spread widening—increases in the difference between the yields on corporate debt and comparable-maturity Treasuries—has also occurred, due to investor skittishness around interest rate volatility and the supply/demand dynamics outlined above. Importantly, there are few signs that the spread widening has been driven by investor concerns that corporate fundamentals may be deteriorating. In fact, fundamentals remain broadly solid and high-yield spreads, in particular, corroborate this.

Though spreads have widened meaningfully from their low point in early February 2018, they remain tight on a historical basis, and are tighter than their 5- and 10-year averages [Figure 3].

Another way to gauge investor concern around deteriorating credit conditions is to look at the spread between the yield of high-yield corporate bonds and IG corporate bonds—instead of Treasuries. This spread is also well below its 5- and 10-year average, indicating that spread widening in IG corporates is primarily a result of investors demanding a yield premium due to the threat of interest rate volatility and the changing supply/demand landscape, as opposed to investor fears that corporate fundamentals are weakening.

CONCLUSION

We remain constructive on IG corporates due to the incremental yield over Treasuries and the ongoing solid backdrop for the global economy and corporate America. Although there have been headwinds for the group year to date, largely due to rising rates, the remainder of 2018 may be kinder to IG corporate investors. ■

3 THOUGH AT 1-YEAR HIGHS, IG SPREADS REMAIN WELL CONTAINED

Source: LPL Research, Bloomberg 06/07/18

Past performance is no guarantee of future results.

The difference between rates for first-class government bonds and investment-grade bonds is called investment-grade spread. The range of this spread is an indicator of the market's belief in the stability of the economy.

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.

High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

The risks associated with investment-grade corporate bonds are considered significantly higher than those associated with first-class government bonds.

INDEX DEFINITIONS

The Bloomberg Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year.

The Bloomberg Barclays U.S. Aggregate Credit Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Bloomberg Barclays U.S. MBS Index measures the performance of investment grade mortgage-backed securities of FNMA, GNMA, and FHLMC.

DEFINITIONS

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semiannually and the income that holders receive is only taxed at the federal level.

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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