LPL RESEARCH

BOND MARKET PERSPECTIVES

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CURVE BALL

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KEY TAKEAWAYS

For just the second time in the last 30 calendar years, short-term 2-year Treasury yields increased while longer-term 10- and 30-year Treasury yields fell.

One factor from 2014 that remains in place at the start of 2015 is the lure of Treasury yields on a global basis.

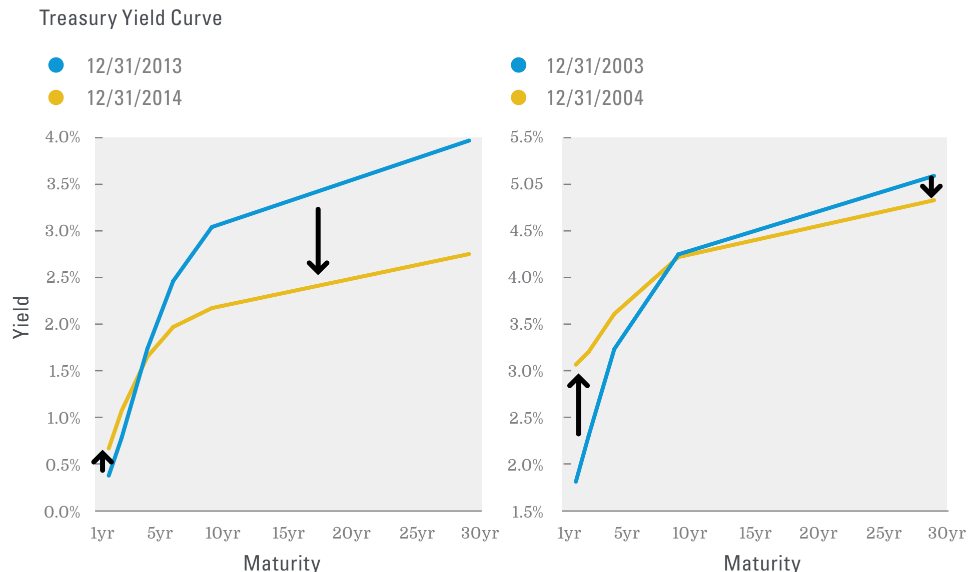
Although bonds may continue to be supported by lower oil prices and European growth fears, we believe U.S. economic growth and the start of Fed rate hikes will translate to a lower-return environment than investors experienced in 2014.

The notable decline in 10- and 30-year Treasury yields was one of the main stories of 2014, but lost in that focus was the rise in short-term Treasury yields. While it is not uncommon for the yield differential between short- and long-term bonds to change over time, the way yields changed was extremely rare and threw investors a curve ball.

For just the second time in the last 30 calendar years, short-term 2-year Treasury yields increased while longer-term 10- and 30-year Treasury yields fell. The yield on the 2-year nearly doubled, moving from 0.39% to 0.67%, in contrast to 10- and 30-year rates falling sharply from 3.04% to 2.17% and 3.96% to 2.75%, respectively [Figure 1].

Prior to 2014, the only other occurrence of such a yield curve shift over the past 30 calendar years took place in 2004. In 2004, short-term rates moved in anticipation of, and later in response to, Federal Reserve (Fed) rate hikes, which began in June 2004 [Figure 1]. Note that this shift did not portend a recession in 2005 and we similarly do not expect a recession in 2015. In 2014, short-term yields rose in anticipation of short-term rate hikes expected in 2015. Although timing was slightly different, the cause of both moves was forthcoming Fed rate hikes. The extraordinarily low level of short-term rates in recent years caused the bond market in 2014 to push up short-term yields earlier than prior history.

1 ONLY 2004 WITNESSED A SIMILAR CHANGE IN THE SHAPE OF THE YIELD CURVE AS IN 2014



Source: LPL Financial Research, Bloomberg 01/05/14.

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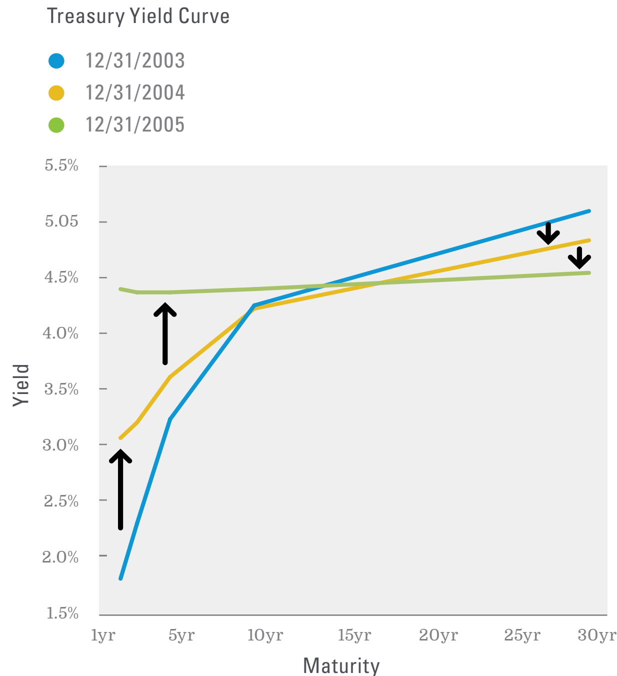
2 **IN 2005, THE YIELD CURVE CONTINUED TO FLATTEN WITH LONG-TERM YIELDS FALLING AGAIN**

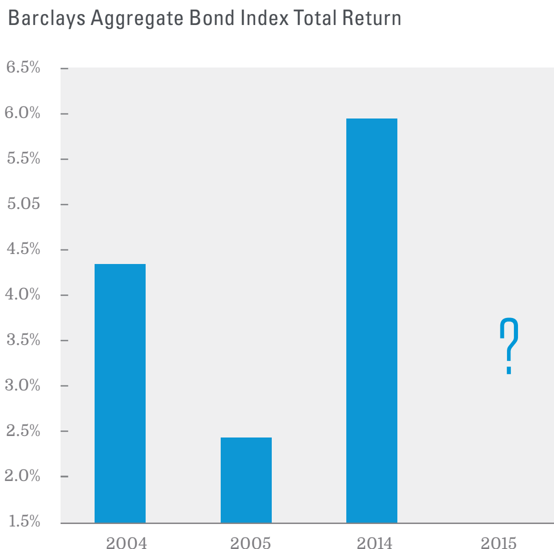
Treasury Yield Curve



Source: LPL Financial Research, Bloomberg 01/05/14

3 **IF 2015 FOLLOWS 2005 FORM, LOWER RETURNS ARE LIKELY**

Barclays Aggregate Bond Index Total Return



Source: LPL Financial Research, Barclays Index data 01/05/14

All performance referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

The yield curve does typically "flatten" (represented by a flatter line when plotting yields across the maturity spectrum on a chart) ahead of expected Fed interest rate increases, but this has usually translated into higher short-term and higher long-term bond yields. In this case, the yield curve flattens in response to short-term yields rising more than long-term yields, as short-term yields are more directly impacted by Fed rate hikes. This is known as a bearish flattener, as it usually translates to weaker total returns for bond investors. A bullish flattener, a situation where long-term rates fall more than short-term yields, represents expectations of slower economic growth from the bond market and is typically a positive for bond investors.

CONUNDRUM REVISITED

The last time the Fed embarked on a rate hike campaign was 2004, so the 2004–2005 experience may reveal what 2014 could mean for investors in 2015. The relative resilience of long-term bond prices in the face of steady interest rate hikes from mid-2004 through mid-2006 caused a puzzled former Fed Chair Alan Greenspan to label it a "conundrum."

In 2005, the yield curve continued its flattening trend with long-term yields falling again, albeit modestly, while short and intermediate yields continued to rise [Figure 2]. Note that the decline in 30-year Treasury yields in 2004 was relatively modest compared with the sharp 1.2% decline of 2014, making a repeat of 2014 unlikely. Still, the 2004 experience shows that longer-term bond yields may remain resilient despite the potential start of Fed rate hikes later this year. We expect there may be a modest rise in longer-term rates for 2015.

MUTED RETURNS

The more important takeaway for investors may be lower total returns. In 2005, the further flattening of the yield curve created a year in which returns were muted across fixed income sectors [Figure 3]. The outcome of 2005 is in-line with

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our expectations for flat bond returns in 2015, as noted in our *Outlook 2015: In Transit* publication. Additionally, the lower absolute level of yields to start 2015 also suggests bond total returns may be lower than in 2005.

FOREIGN INFLUENCES STILL STRONG

One factor from 2014 that remains in place at the start of 2015 is the attractiveness of Treasuries on a global basis. The German 10-year government bond yield has fallen to 0.5% and the German 5-year to 0.0%, well below the 1.6% of the 5-year Treasury. Treasuries continue to draw global interest, especially given ongoing bond buying by the Bank of Japan and expectations that the European Central Bank may start buying government bonds in coming months.

In combination with a reduced supply of high-quality government bonds, longer-term bonds have continued to garner support. At some point, continued increases in short-term yields or ebbing of dollar strength may change the attractiveness of longer-term debt to global investors. Although bonds may continue to be supported by lower oil prices and European growth fears, we believe U.S. economic growth and the start of Fed rate hikes will potentially translate to a lower-return environment than investors experienced in 2014. ■

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.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

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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