LPL RESEARCH

BOND MARKET PERSPECTIVES

April 17 2018

KEEPING IT REAL

John Lynch *Chief Investment Strategist, LPL Financial*
Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Real (inflation-adjusted) yields can be important barometers of the state of monetary conditions.

The meaningful rise in real yields in early 2018 may have contributed to equity market weakness.

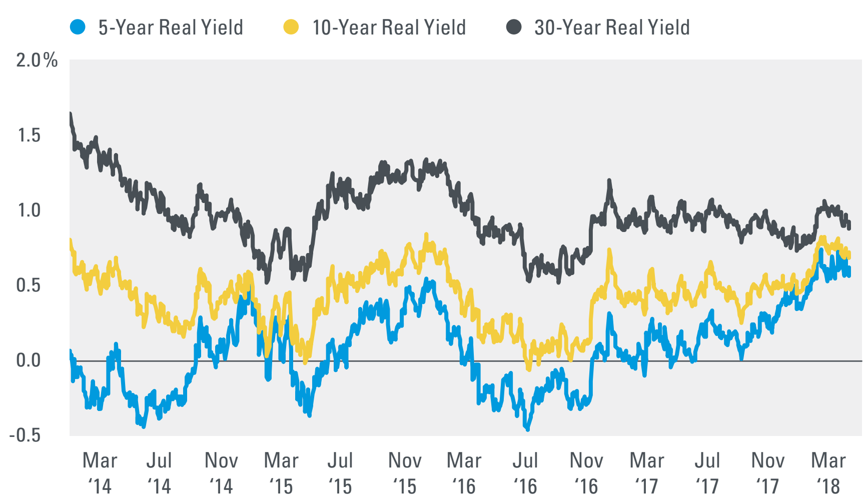
However, the subsequent modest decline of real yields may have eased some of the pressure on equities.

After a substantive increase in the first months of 2018, real yields have slowly declined, a positive indicator for stock and bond markets, as they suggest lower true cost of debt for domestic companies. A bond yielding 4%, with inflation at 2%, has a real (inflation-adjusted) yield of 2%. Real yields can be seen as compensation investors receive for higher future growth rates, inflation volatility, and a potentially more active Federal Reserve (Fed). Indications of higher levels of growth and inflation, and thus a more aggressive Fed tightening schedule, led to a sharp rise in real yields in early 2018, which may have contributed to equity market weakness. This is because rising real yields can lead to higher borrowing costs and tighter financial conditions, which can be a headwind for risk assets. Thus, the decline we have seen in the last two months has been welcome news to equity markets, which had been at least somewhat worried about the rise in real yields year to date.

REAL INDECISION

Real interest rates of various maturities have converged over the last several years, with shorter maturities rising and longer maturities staying relatively constant. This, in our view, indicates a lack of clarity from market participants as to the future direction of growth in the economy [Figure 1].

1 REAL YIELDS OF VARIOUS TREASURY MATURITIES HAVE CONVERGED, INDICATING INDECISION



Source: LPL Research, Bloomberg 04/16/18

Performance is historical and no guarantee of future results.

Real yield represents the inflation adjusted yields of the above Treasuries.

There are other implications for the convergence of real yield levels across the real yield curve. One of these is the flattening of the nominal yield curve. Throughout 2017, and year to date, the Treasury yield curve has been flattening. An inverted yield curve has historically been a good indicator of recessions, and has preceded each of the last nine recessions going back to 1955. On average, an inversion has led the subsequent recession by about five quarters; in the most recent recession in 2008, it was eight quarters. We have previously discussed why this indicator may not have quite the efficacy it once did, due to global central bank intervention suppressing long-term interest rates. Additionally, the yield curve remains quite a distance from actually inverting, and is not an overly concerning indicator at this time, though it warrants ongoing monitoring.

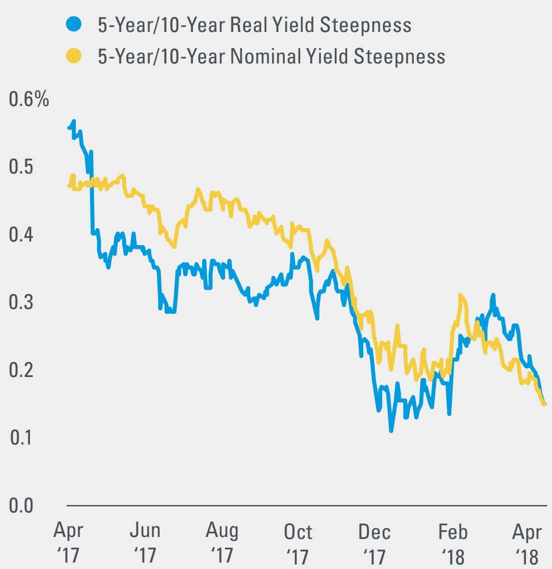
As shown in Figure 2, the flattening of the curve over the past year has been driven primarily by the flattening of the real yields curve.

REAL TIGHTENING

Although the Fed has been raising interest rates since December 2015, monetary policy has in aggregate been growing more accommodative since then, somewhat counterintuitively. That is, until real yields started their march higher in early 2018. Not coincidentally, financial conditions also became more restrictive and equity market volatility reared its head [Figure 3].

Real yields remain an important indicator of tightness in monetary conditions and can help clarify the direction equity markets are headed. Although real yields have risen in the recent past, they remain in their 75 basis point (0.75%) range that they have been in since 2013. A breakout in real yields, above the 0.92% 5-year high in September 2013 or above the critical psychological 1% level, could represent another headwind for equities and other risk assets.

2 THE FLATTENING YIELD CURVE HAS BEEN DRIVEN MAINLY BY FLATTENING REAL YIELDS OF TREASURIES

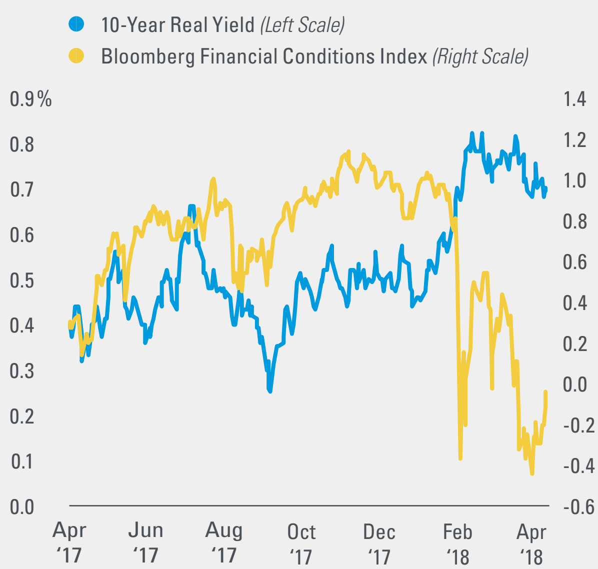


Source: LPL Research, Bloomberg 04/16/18

Performance is historical and no guarantee of future results.

Real yield represents the inflation adjusted yields of the above Treasuries.

3 RISING REAL YIELDS MAY HAVE CONTRIBUTED TO EQUITY MARKET WEAKNESS



Source: LPL Research, Bloomberg 04/16/18

Performance is historical and no guarantee of future results.

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 Bloomberg Financial Conditions Index is an important gauge of the overall financial and credit markets conditions in the United States.

CONCLUSION

Real yields remain an important barometer of monetary conditions within the economy. Higher real yields year to date indicate that investors expect higher levels of growth and that the pace of Fed rate hikes may potentially accelerate as inflation notches higher. While real yields have rolled over very recently, they continue to be a solid gauge of the true borrowing costs for companies, with significant implications for the direction of stock and bond markets alike. ■

DEFINITIONS

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 3-month, 2-year, 5-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.

RES 48131 0418 | For Client Use | Tracking #1-720913 (Exp. 04/19)