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FLATTENING EXPECTATIONS

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KEY TAKEAWAYS

A flattening Treasury yield curve along with declining long-term rate hike expectations are pessimistic indicators from fixed income markets.

The Fed's desire to reduce the size of its balance sheet may be exacerbating the declines in longer-term rate hike expectations.

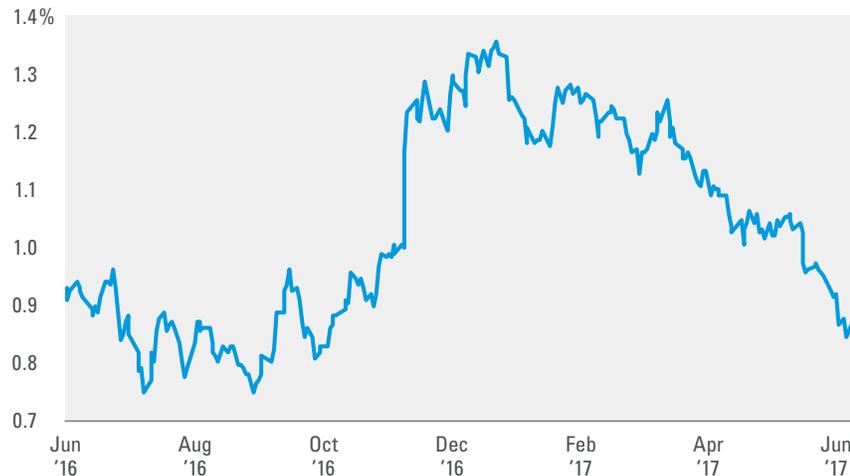
The Treasury market's posture is out of step with equity markets, which have continued moving higher throughout the year.

Recent Treasury yield curve flattening and a decline in longer-term rate hike expectations may be warning signs from fixed income markets.

Yet, those signs are seemingly incongruous with continued equity market strength. Some of the changes in rate hike expectations may involve the Federal Reserve's (Fed) new focus on balance sheet normalization; however, the disparity between postures of equity and fixed income markets means that only time will tell which market is reading the U.S. economy correctly. In reality, the likely answer lies somewhere in between the two markets.

1 TREASURY YIELD CURVE IS NEAR ITS FLATTEST POINT YEAR TO DATE

● 2-Year/10-Year Treasury Yield Curve Steepness



Source: LPL Research, Bloomberg 06/12/17

Performance illustrated 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 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.

FLATTENING YIELD CURVE

Year to date, the Treasury yield curve has flattened considerably. This is largely out of step with continued equity market strength, and marks a potential warning sign from the fixed income market. The steepness of the yield curve, the difference between longer- and shorter-term Treasury yields, can be seen as a proxy for future growth and inflation expectations. If a high rate of growth and inflation are expected, fixed income investors will demand more of a premium to lock in their money at prevailing interest rates for a longer period of time. After peaking at a steepness of 1.36% on December 22, 2016, the curve has flattened considerably to 0.87% as of June 8, 2017, below its pre-election level [Figure 1]. Despite this cautious indicator from fixed income markets, equity markets have continued to plow ahead, with the S&P 500 Index up 9.7% on a total return basis year to date through June 8, 2017.

WHAT'S DRIVING THE DECLINE?

Since the multi-year high (2.62%) of the 10-year Treasury yield on March 13, 2017, the yield has fallen more than 40 basis points to 2.19% as of June 8, 2017. The driver of this decline has been almost exactly split between declining growth and inflation expectations, with each falling 22 basis points (0.22%) over the period. This may indicate that the decline is not solely focused on a particular driver like a decline in the price of oil, for example, which would likely have an outsized impact on the inflation part of the equation. For example, the nearly 1% drop in the 10-year Treasury from the end of June 2014 to mid-February 2016 was caused entirely by declining inflation expectations, which also fell about 1%, as a result of the decline in the price of oil. Over that same time period, the 10-year real rate (the 10-

year TIPS yield) actually rose. The recent decline in growth and inflation expectations indicates that the decline is more fundamentally based, and perhaps less transitory, than the situation we saw with oil over the previous three years.

LONG-TERM RATE HIKE EXPECTATIONS

While a Fed rate hike during the June 13–14, 2017 meeting has been largely priced in by the markets, a subtle shift has been occurring over the last month within the fed funds market. While the number of rate hikes implied by the fed funds market for the remainder of 2017 has been fairly consistent, the full-year number for 2018 and 2019 has fallen meaningfully [Figure 2]. So the market may be indicating that while the Fed has effectively boxed itself into a rate hike in June, it may slow the pace of hikes in the coming years. As of June 8, 2017, the fed funds market is implying just 1.8 rate hikes over 2018 and 2019 combined, or less than one per year.

BALANCE SHEET INFLUENCE?

Part of the change in longer-term rate hike expectations may be due to the Fed's discussion of reducing its balance sheet. The latest expansion of the Fed's balance sheet ended more than two years ago (October 2014), but the Fed has rolled proceeds from maturing bonds into new purchases. This has kept the size of its balance sheet relatively constant at roughly \$4.2T and also likely kept interest rates slightly lower than they otherwise would be. Normalizing the balance sheet may push longer term rates higher, as there will be one less buyer, and thus less demand. This may result in the yield curve steepening, which could be helpful for financial firms and the economy at large. It may

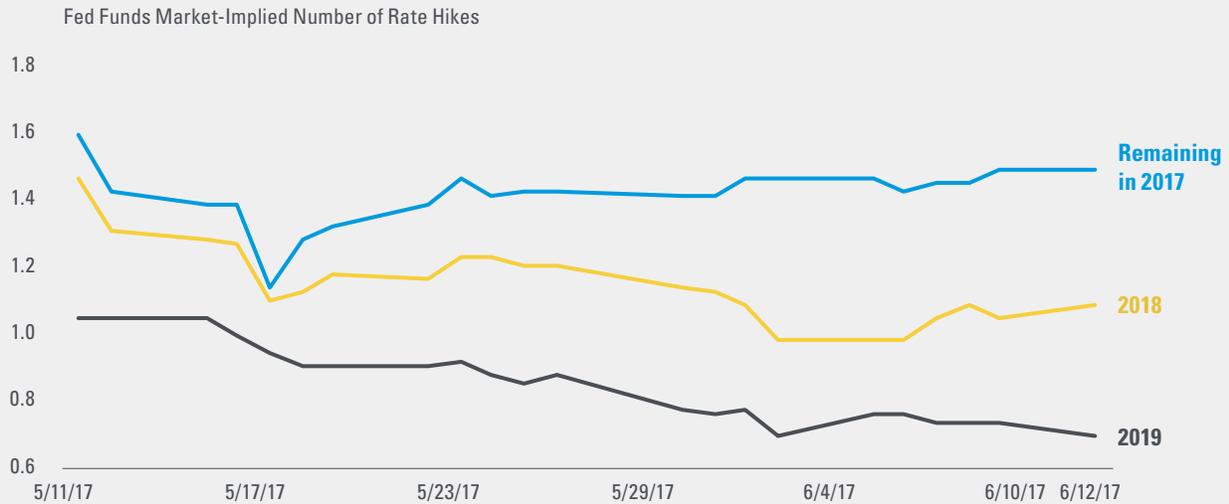
The principal of Treasury inflation-protected securities (TIPS) is adjusted semiannually for inflation based on the Consumer Price Index (CPI)-while providing a real rate of return guaranteed by the U.S. government.

also be done at the expense of rate hikes, as one tool is used rather than the other, if doing both simultaneously is deemed to be too jarring for fixed income markets and too risky to employ. More emphasis on balance sheet reduction may be a sign to the markets that rate hikes are less likely, or at least may be more gradual than previously anticipated. For more information on global central bank balance sheets, please see our recent [Bond Market Perspectives](#).

CONCLUSION

Stock and bond markets are sending mixed messages when it comes to expectations for economic growth. The bond market may be viewing the situation more pessimistically, evidenced by the flattening of the yield curve, and a decline in longer-term rate hike expectations. The stock market has shrugged off these concerns and continues to grind higher. Only time will tell which is right, or maybe the answer lies somewhere in between... ■

2 RATE HIKE EXPECTATIONS FOR 2018 AND 2019 HAVE DECLINED



Source: LPL Research, Bloomberg 06/12/17

Market implied rate hike expectations are calculated based on the pricing of various fed funds futures contracts. Rate hike expectations may not develop as predicted.

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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.

INDEX DEFINITION

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.

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