LPL RESEARCH
WEEKLY MARKET COMMENTARY

June 29 2020

THE FUTURE OF FIXED INCOME

Ryan Detrick, CMT, *Senior Market Strategist, LPL Financial*
Jeffrey Buchbinder, CFA, *Equity Strategist, LPL Financial*
Barry Gilbert, PhD, CFA, *Asset Allocation Strategist, LPL Financial*

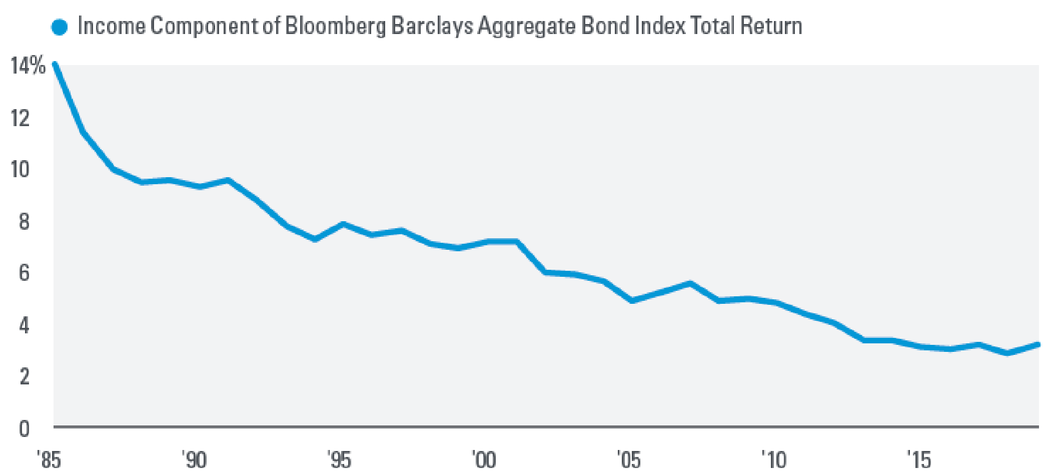
Although the US economic recovery has picked up and we expect yields to rise in the second half of 2020, structural forces may help limit the size of the move. The pandemic-driven demand shock, the Federal Reserve, and disinflationary pressures may likely keep yields low for quite some time.

DOWNWARD PRESSURES ON YIELDS REMAIN

The US economic outlook has improved quite a bit since March, as more evidence of economic recovery has emerged in timelier economic data. The record hiring evident in the May US Bureau of Labor Statistics jobs report and the record surge in retail sales last month per the US Census Bureau are two examples of how the economic recovery since the peak of the lockdowns in April has surprised many economists. However, the improving growth outlook that the stock market has been pricing in has not translated into much of a move on the bond side. Further, inflation pressures remain well contained—and are likely to stay that way for some time—and the Federal Reserve's (Fed) stance hasn't changed.

As a result, we have reduced our base case year-end 2020 forecast for the 10-year US Treasury yield from 1.25–1.75% to 1–1.5%. While still an increase from current levels, if realized, this would be the lowest level to end a year on record.

1 BOND INCOME HAS BEEN DECLINING FOR DECADES



Source: LPL Research, FactSet 06/26/20

LPL Financial

THE FED IS KEEPING RATES WELL ANCHORED

The Fed is unlikely to hike (or cut) rates in 2020, and may not do so in 2021 either—even if the economic recovery becomes a little better than we expect. Persistently low inflation during the last expansion may minimize any Fed concerns that it needs to raise rates preemptively to keep inflation under control. Consistent with its messaging, we expect the Fed to remain accommodative for some time, and raising rates probably won't be on the table until after it ends its bond purchases.

The Fed may even consider instituting some form of yield curve control by setting a target cap for rates at maturities possibly as far out as five years. In that scenario, the central bank would buy enough Treasuries to keep rates below that threshold, which would further help anchor rates for longer-maturity bonds. For now, even the possibility of such a program has helped keep rates lower at the shorter end of the curve.

CHALLENGE FOR INCOME INVESTORS

These historically low rates have continued to hurt savers while introducing interest-rate risk for bond investors looking for more yield at longer maturities. Investors seeking income are in a tough spot. Rising Treasury yields can weigh on bond prices, eating away at interest income and gains from tighter credit spreads relative to Treasuries. With the credit spread for the Bloomberg Barclays Aggregate Bond Index already near the average for the last economic cycle, and interest income at historically low levels, we expect the index's returns to be near flat for the rest of 2020, with some risk of losses **[Figure 1]**. However, it would take a move above our new target yield range forecast to erase gains from the first half of the year.

DOWNSIDE RISK TO YIELDS

Core bonds, particularly Treasuries, may benefit if a downside scenario emerges, such as a second wave of COVID-19 cases accompanied by renewed stock market volatility. In that case, the 10-year Treasury yield could potentially fall back to 0.5% or lower and boost broad bond market returns, based on the Bloomberg Barclays Aggregate Bond Index. Although this is not our base-case scenario, it does highlight why suitable investors may consider the potential diversifying benefit of bonds.

The subject of negative rates has also been a hot-button issue, as investors are concerned that experimental policy rates implemented internationally will make their way to the United States. We think that is an unlikely scenario, even if a second wave of COVID-19 leads to more lockdowns, based on recent comments by Fed officials and the lack of evidence that the policy has been effective in other countries.

CURRENT RECOMMENDATIONS: INVESTING FOR RECOVERY

We would recommend that suitable investors consider positioning portfolios with below-benchmark interest-rate sensitivity and near-benchmark credit quality. We favor mortgage-backed securities (MBS) for their combination of interest income and limited rate sensitivity. We are neutral on investment-grade corporate bonds with valuations no longer attractive and leverage increasing, but we still see incremental value for corporate bonds over Treasuries.

Suitable investors may want to consider increasing exposure to dividend-paying equities for income rather than over-emphasizing the credit-sensitive bond sectors, although these bond sectors can play a role in well-diversified portfolios. Among those sectors, we would favor a mix of dollar-denominated emerging market debt and high-yield bonds. We believe emerging market debt may likely benefit from the broadly supportive monetary policy environment, and valuations for high yield are still attractive.

Municipal bond yields still look attractive relative to Treasuries for tax-sensitive investors. We maintain a bias toward high-quality municipals and are more cautious on their high-yield counterparts. While federal aid and the Fed's Municipal Liquidity Facility have helped the market stabilize, the pandemic has delivered a big blow to municipal tax receipts, and municipal default risk historically has tended to lag the corporate market.

Thank you to Nick Pergakis for his contribution to this week's Weekly Market Commentary.

IMPORTANT DISCLOSURES

This material is for general information only and is not intended to provide specific advice or recommendations for any individual. There is no assurance that the views or strategies discussed are suitable for all investors or will yield positive outcomes. Investing involves risks including possible loss of principal. Any economic forecasts set forth may not develop as predicted and are subject to change.

References to markets, asset classes, and sectors are generally regarding the corresponding market index. Indexes are unmanaged statistical composites and cannot be invested into directly. Index performance is not indicative of the performance of any investment and do not reflect fees, expenses, or sales charges. All performance referenced is historical and is no guarantee of future results.

Any company names noted herein are for educational purposes only and not an indication of trading intent or a solicitation of their products or services. LPL Financial doesn't provide research on individual equities.

All information is believed to be from reliable sources; however, LPL Financial makes no representation as to its completeness or accuracy.

Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Corporate bonds are considered higher risk than government bonds. Municipal bonds are subject to availability and change in price. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply. If sold prior to maturity, capital gains tax could apply. U.S. Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

Mortgage backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment-grade fixed-rate bond market, including both government and corporate bonds.

Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. Credit ratings are published rankings based on detailed financial analyses by a credit bureau specifically as it relates the bond issue's ability to meet debt obligations. The highest rating is AAA, and the lowest is D. Securities with credit ratings of BBB and above are considered investment grade. The credit spread is the yield the corporate bonds less the yield on comparable maturity Treasury debt. This is a market-based estimate of the amount of fear in the bond market. Base-rated bonds are the lowest quality bonds that are considered investment-grade, rather than high-yield. They best reflect the stresses across the quality spectrum.

International debt securities involve special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards. These risks are often heightened for investments in emerging markets.

All index data from FactSet.

Please read the full Outlook 2020: Bringing Markets into Focus publication for additional description and disclosure.