LPL RESEARCH
BOND MARKET PERSPECTIVES

June 5 2018

LESSONS FROM QUITALY

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

KEY TAKEAWAYS

Market reaction to Italy's political woes was swift and pronounced, but ultimately overdone.

Nonetheless, it highlighted key differences in investor perceptions of European countries' risks.

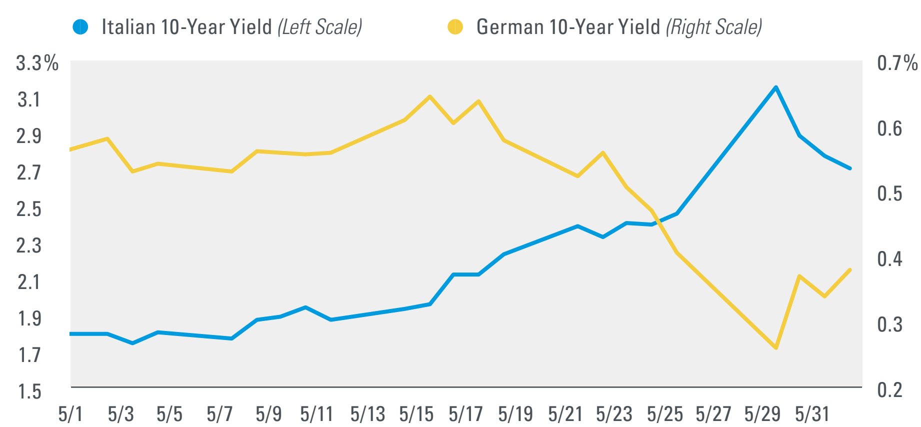
The Italy episode also exemplified the value of high-quality fixed income as a risk mitigation tool in diversified portfolios.

In hindsight, markets may have overreacted to Italian political risk, but the recent episode highlighted country-specific risk and the potential diversification benefits of high-quality fixed income broadly. Three months after Italy's election, political uncertainty led to heightened concern that Italy's populist coalition may try to pull Italy out of the European Union (EU) and Eurozone (countries that use the euro as their currency). The potential for Italy to be operating outside of the Eurozone prompted investors to reassess the risk of Italy's government debt, leading to a large sell-off in Italian government bonds. Short- and long-term yields rose dramatically, with the Italian 2-year bond's yield moving from 0.5% to 2.7% over two trading days (May 28–29, 2018). On May 8, just three weeks prior, that same bond was yielding -0.3%. The flight from Italian bonds led to a short-term sell-off, in which stocks fell globally and investors flocked to safe-haven assets like U.S. Treasuries.* These moves have partially reversed in the week since, though Italian bond yields remain elevated. Notably, it's essential to note that the market reaction reaffirmed our view that high-quality fixed income can function as a critical equity risk ballast in diversified portfolios.

REGIONAL DIFFERENCES

Importantly, the sell-off in government debt did not hit Europe equally. In fact, yields in Germany actually fell, indicating that European investors sought refuge in the perceived safety of German government bonds [Figure 1]. Similarly, yields on U.S. government

1 YIELDS WITHIN EUROPE SHOWED DIFFERENTIATION DURING RISK-OFF MOVE



Source: LPL Research, Bloomberg 06/04/18

Past performance is no guarantee of future results.

*U.S. treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit and market risk. They 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.

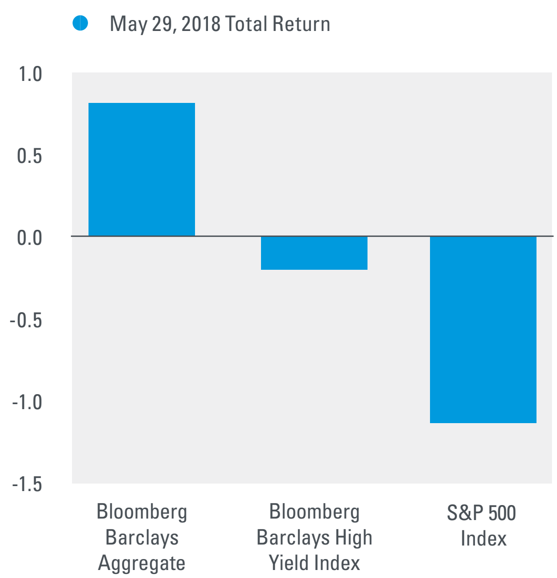
debt also declined meaningfully. The flagship 10-year Treasury fell in yield by 15 basis points (0.15%), its largest daily decline in almost two years. Short-term yields declined in the U.S. as well, with the 2-year Treasury dropping 16 basis points (0.16%).

HIGH-QUALITY DOES ITS JOB

Domestic high-quality fixed income's reaction to the broad, global risk-off tone was encouraging [Figure 2]. High-quality fixed income performed its primary job of being an equity risk mitigation tool. As is typically the case during strong risk-off moves, lower-quality fixed income (like high yield bonds) performed better than equities, but did not provide the same diversification benefit of higher-quality fixed income.

With domestic rates having rebounded somewhat since last week, the U.S. retains a near-historic yield advantage to many other developed nations. Treasuries' yield advantage to the German bund is at its highest level in history [Figure 3]. This could remain elevated, or even move higher, if downside risk in Europe becomes more pronounced, further hampering the European Central Bank's ability to raise interest rates. The yield advantage relative to Japanese government bonds also remains high, even on a fully currency-hedged basis, possibly enticing Japanese investors to invest more in U.S. debt at current levels. All else equal, foreign demand could be a factor that keeps Treasury yields at lower levels than they may otherwise be.

2 HIGH-QUALITY FIXED INCOME HELPED BUFFER EQUITY MARKET WEAKNESS

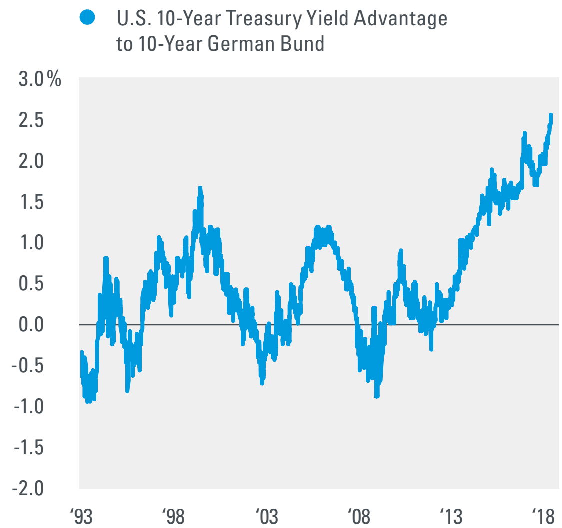


Source: LPL Research, Bloomberg 06/04/18

Past performance is no guarantee of future results.

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.

3 U.S. YIELD ADVANTAGE TO GERMANY REMAINS AT ALL-TIME HIGH



Source: LPL Research, Bloomberg 06/04/18

Past performance is no guarantee of future results.

LPL Financial

RATE HIKE IMPLICATIONS

The moves in interest rates carried other weight, such as implications for future Federal Reserve (Fed) rate hikes. Investors, concerned that political risk in Italy could help contribute to slower global economic growth, which would put downward pressure on inflation, lowered their expectations for future Fed rate hikes. On May 22, the market-implied number of total Fed rate hikes in 2018 was approximately 3.5, with investors evenly split regarding whether the Fed would hike rates a total of three or four times this year. That number fell considerably by May 29, with the market pricing in just over 2.5 hikes total. In essence, investors perceived the mounting risks in Europe to warrant almost one less rate hike this year than just one week prior, a meaningful shift in investor sentiment.

Those moves have partially reversed after markets digested the news and backed off of the worst-case scenario mindset. Fed funds future markets are currently pricing in over three rate hikes total in 2018 but leaning toward three relative to four, in line with our view of three hikes being most likely.

CONCLUSION

As is usually the case, markets appear to have overreacted in the short term. We do not see Italy leaving the EU, but we expect continued political unrest in Europe as anti-establishment parties and referendums proliferate. We think the global economic backdrop, particularly in the U.S., remains intact. Although we believe the situation in Italy is an ongoing risk worth monitoring, we don't believe it is the bellwether of a large change in the trajectory of the global economy. Importantly for fixed income investors, this episode highlighted the differentiation between countries in Europe and investors' perceptions of their risk profiles. It also exemplified high-quality fixed income's role in balanced portfolios: a potential diversification benefit, particularly amid equity market weakness. ■

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.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not protect against market risk.

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.

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.

INDEX DEFINITIONS

The Bloomberg Barclays High-Yield Bond Index is an unmanaged index of corporate bonds rated below investment grade by Moody's, S&P or Fitch Investor Service. The index also includes bonds not rated by the ratings agencies.

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 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.

DEFINITIONS

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

RES 80585 0618 | For Client Use | Tracking #1-737070 (Exp. 06/19)