THE RATE AND CREDIT VIEW

The Case For Fixed Income After A Fed Pause

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Lawrence Gillum, CFA,
Chief Fixed Income Strategist

Josh Whitmore, CFA,
Senior Fixed Income Analyst

EXECUTIVE SUMMARY

- The LPL Research Strategic and Tactical Asset Allocation Committee (STAAC) recommends a neutral duration position relative to benchmarks and an underweight allocation to cash.

- While short-term rates are currently elevated, the risk is that these rates won't last and, upon maturity, cash investors will have to reinvest proceeds at lower yields.

- After the Fed stops raising rates, historically, yields on both shorter and intermediate maturity Treasury securities have fallen by 1.5% and 1%, respectively. Corporate spreads were mixed.

- And since we're starting to see positive signs of inflationary pressures easing (along with cracks in the regional banking sector), it is likely the Fed is done with its rate hiking campaign, which should allow core bonds to outperform cash and other short-maturity fixed income strategies.

BALANCING SHORT-TERM OPPORTUNITIES WITH LONGER-TERM OBJECTIVES

After the most aggressive rate hiking campaign in decades from the Federal Reserve (Fed), short-term interest rates are at levels last seen early in the 2000s. Moreover, due to the elevated fed funds rate and the subsequent carryover into the U.S. Treasury market, the Treasury yield curve is the most inverted since the early 1980s (that is shorter-term Treasury securities out yield longer maturity securities). This has (finally) allowed investors to generate a return on cash. But, economists like to remind us there is no such thing as a free lunch. In investment parlance, that just means all investments carry risk—even cash. So where is the risk that economist warn us about? The big risk with cash is reinvestment risk. That is, while short-term rates are currently elevated, the risk is that these rates won't last and, upon maturity, investors will have to reinvest proceeds at lower rates.

The Fed's goal has been to take the fed funds rate into restrictive territory to make the cost of capital prohibitively expensive to slow aggregate demand, which should allow inflationary pressures to abate. Then what? Well, after winning its fight with inflation, markets expect the Fed to start cutting rates as early as this year. After keeping rates at these elevated levels, the Fed will then likely take the fed funds rate back to a more neutral level, which economists believe is 2.5% or even lower. Just as the aggressive rate hiking cycle took Treasury yields higher, interest rate cuts will take Treasury (and other bond market) yields lower. This is when the reinvestment risks will show up. Since we're starting to see positive signs of inflationary pressures easing (along with cracks in the regional banking sector), it is likely the Fed is done with its rate hiking campaign, which could be welcome news for core bonds.

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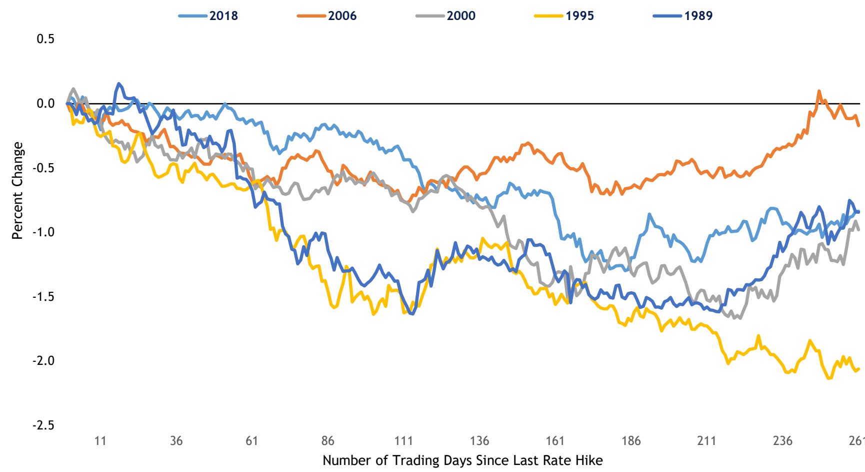
In fact, if the Fed is indeed done raising interest rates we could start to see lower yields on intermediate-term securities before the Fed actually cuts rates. Of the most recent Fed rate hiking campaigns (**Figure 1**), 10-year Treasury yields were lower, on average, by 1% after the Fed stopped raising rates. And while our base case remains a trading range for the 10-year yield between 3.25% and 3.75% throughout 2023 (similar to the 2006 Fed rate hiking campaign when the Fed kept rates at elevated levels for over a year), we acknowledge that there is a strong bias for yields to end the year lower than our expectations, which could mean strong positive returns for core bonds.

1 If the Fed Is Done, We Could See Lower Treasury Yields (10-year Treasury)

10-Year Treasury yields have generally been lower by 1% after the last Fed rate hike.

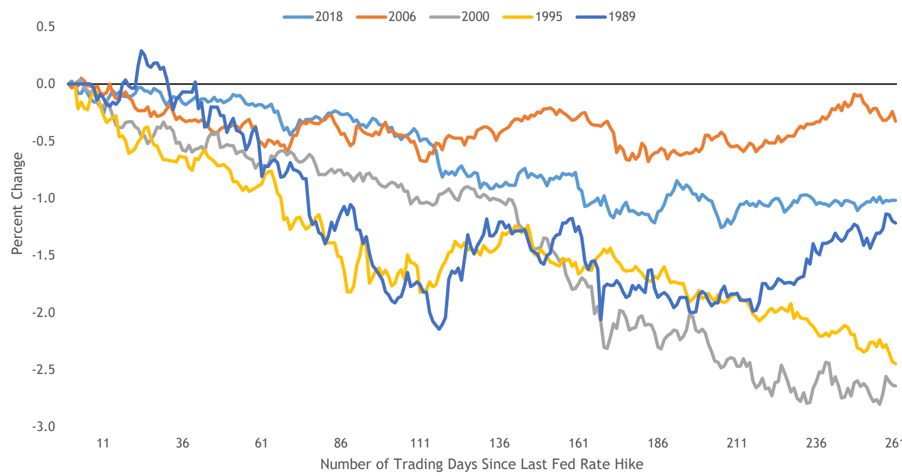


Source: LPL Research, Bloomberg, 05/22/23
Past performance is no guarantee of future results.

And while 10-year Treasury yields were lower by 1%, on average, over the next 12 months, the largest declines were from shorter maturity Treasuries. Two-year Treasuries (**Figure 2**), which are generally more sensitive to change monetary policy, declined by 1.5%, on average.

Because shorter maturity Treasury yields fell more than longer maturity securities, the Treasury yield curve steepened by roughly 0.50%, on average. Currently, the (benchmark) two-year yield is out-yielding the (benchmark) 10-year Treasury yield by close to 0.60%, which may mean we're unlikely going to get back to a normal, upward shaped yield curve unless we deviate from historical averages.

2 2-Year Treasury Yields Have Generally Been Lower by 1.5% After the Last Fed Rate



Source: LPL Research, Bloomberg, 05/22/23
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Two-year Treasury yields are generally more sensitive to changes in Fed monetary policy.

A 1% decline in intermediate-term rates equates to a greater impact on returns than a 1.5% decline in short-term rates.

While historically the front of the Treasury curve has declined more than the intermediate portion of the curve following a pause in the Fed hiking cycle, that does not equate to higher returns for investors holding shorter-term Treasuries. Given the mechanics of fixed income returns, a 1% decline in intermediate-term rates equates to a greater impact on returns than a 1.5% decline in short-term rates. As you move further out on the curve, duration increases and correspondingly increases the return impact from changes in interest rates (duration is a measure of interest rate sensitivity). As a rule of thumb, a year of duration equals roughly a 1% change in return for every 1% move in rates. For example, a bond with a duration of ten years will appreciate by roughly 10% with a 1% decline in rates. As intermediate-term bonds have a greater duration than short-term bonds, a 1% decline in the 10-year Treasury yields (as described above) will produce a greater return than a 1.5% decline in the 2-year Treasury yield. For the 2-year Treasury to outperform the 10-year Treasury, front end rates would need to decline by more than 5% (versus 1.5% historically).

CORPORATE SPREAD BEHAVIOR MIXED

While the decline in Treasury yields, across the yield curve, was fairly consistent, the behavior of corporate spreads has been mixed (Figure 3). This is not surprising as Fed policy changes have a higher correlation to the rate markets (e.g., Treasuries) than credit markets. Moreover, since Fed rate cuts correlate with lower interest rates, the cost for corporates to issue new debt decreases as well. With the strength of corporate balance sheets in 2023, the likely pause from the Fed this year may result in a rally across fixed income broadly, including corporate credit, which aligns with the 2006 and 2018 periods that had a decline in corporate spreads following the Fed's last rate hike.

3 BAA-Rated Corporate Spreads Were Mixed After the Last Fed Rate Hike

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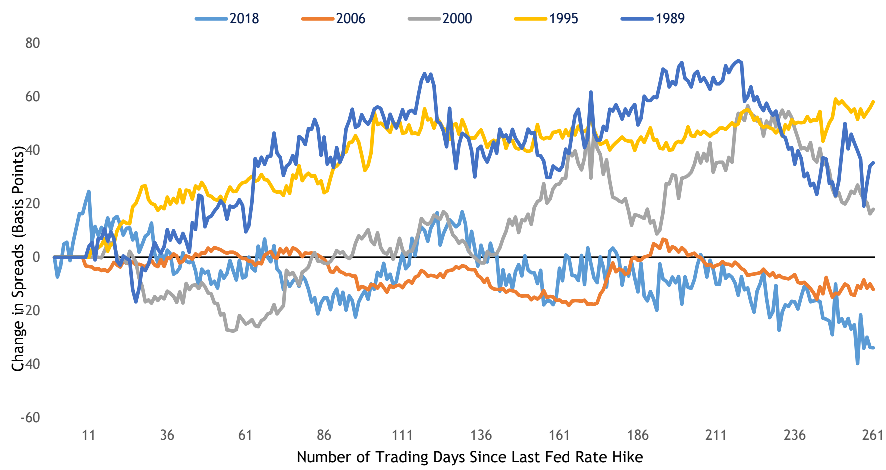

Source: LPL Research, Bloomberg, 05/22/23
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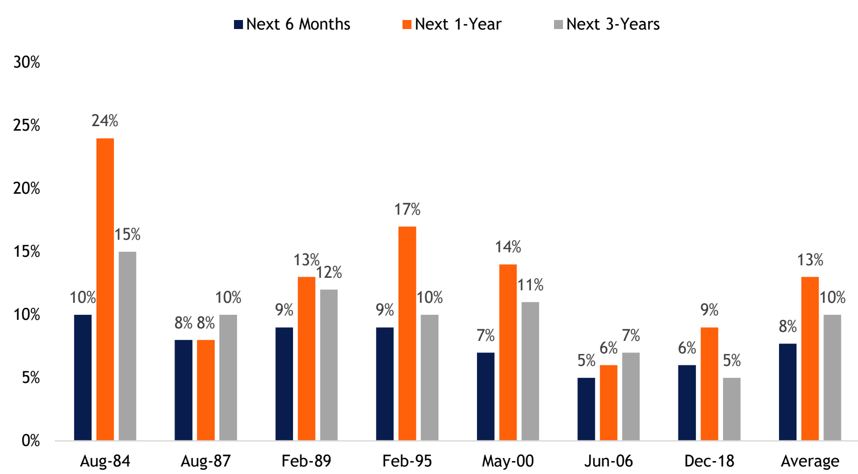
IF HISTORY RHYMES…

It's been said that history doesn't repeat but it does rhyme. So, if history at least rhymes during this cycle and we do see lower yields and stable spread levels over the next year, intermediate core bonds could very well outperform cash and other shorter maturity fixed income strategies. Historically, core bonds, as proxied by the Bloomberg Aggregate Bond Index and seen in Figure 4, have performed well during Fed rate hike pauses. Since 1984, core bonds were able to generate average 6-month and 1-year returns of 8% and 13%, respectively, after the Fed stopped raising rates. Moreover, all periods generated positive returns over the 6-month, 1-year and 3-year horizons.

4 Core Bonds (Bloomberg US Aggregate Index) Tend To Do Well During Fed Pauses

Since 1984, core bonds were able to generate average 6-month and 1-year returns of 8% and 13%, respectively, after the Fed stopped raising rates.



Source: LPL Research, Bloomberg, 05/22/23
All indexes are unmanaged and cannot be invested into directly.
Past performance is no guarantee of future results.

CONCLUSION

Within LPL's discretionary asset allocation models, we've maintained a neutral duration relative to our benchmark (the Bloomberg Aggregate Index) with the expectation that Treasury yields are likely headed lower (or at least not much higher) over the next few quarters. And if yields fall from current levels, investors will have likely missed an opportunity to invest in yields we've not seen in over a decade. While we certainly think cash is a legitimate asset class again, it's all about balancing today's opportunity with what may or may not be available tomorrow. So, unless investors have short-term income needs, they may be better served by reducing some of their excess cash holdings and by extending the maturity profile of their fixed income portfolio to lock in these higher yields for longer. Bond funds and ETFs that track the Bloomberg Aggregate Index, along with separately managed accounts and laddered portfolios, all represent attractive options that will allow investors to take advantage of these higher rates before they're gone.

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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.

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

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

US Treasuries may be considered "safe haven" investments but do carry some degree of risk including interest rate, credit, and market risk. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

The Standard & Poor's 500 Index (S&P500) 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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