LPL RESEARCH
WEEKLY MARKET COMMENTARY

September 3 2019

U.S. TREASURIES AND THE YIELD CURVE

John Lynch, *Chief Investment Strategist, LPL Financial*
Callie Cox, *Senior Analyst, LPL Financial*

We recently reduced our year-end forecast range for the 10-year U.S. Treasury yield from 2.5–2.75% to 1.75–2%. This significant reduction reflects what we consider the many somewhat curious aspects of the domestic and global macroeconomic environments. Trade uncertainty, low inflation, geopolitical risks, monetary policy, and relative valuation all played a role in our decision. To be sure, delayed prospects for a U.S.-China trade agreement remain central to our economic and market projections in the coming months.

We expect the combination of a softer economic growth outlook with mild U.S. inflationary pressures and ultra-low yields internationally to potentially translate into lower domestic yields. The uncertain U.S.-China trade situation has weighed heavily on business investment, resulting in weaker manufacturing activity worldwide. It is also important to note that trade challenges exist beyond the United States and China. The United States' pacts regarding NAFTA 2.0, South Korea and Japan, and European automobiles are still unresolved. Despite a decade's worth of global monetary policy accommodation, very few inflationary pressures are evident, presenting leading central banks with the need for further accommodation.

YIELD CURVE INVERTS FOR THE FIRST TIME SINCE 2007

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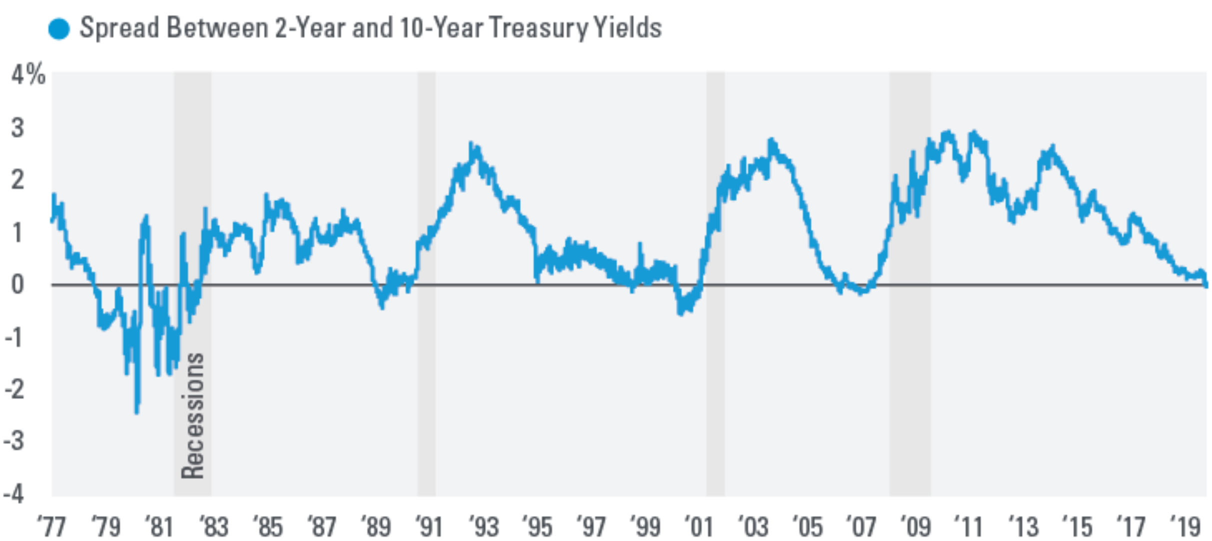

Source: LPL Research, Bloomberg 08/28/19

Yield curve inversion is when long-term yields fall below short-term yields.

THE FED'S ROLE

In recent communications from the Federal Reserve (Fed), including minutes from the July meeting and Fed Chair Jerome Powell's recent speech in Jackson Hole, WY, the central bank has emphasized its intention to "act as appropriate" in order to "sustain the expansion." The Fed, which has a history of ambiguity, has been very clear in recent months. Considering the Fed's official mandate includes ensuring price stability and full employment, another set of factors has arisen in this global environment: interest rate differentials and the impact on currencies.

Global fixed income investors currently have a choice between investing in more than $15 trillion worth of negative-yielding debt or purchasing U.S. Treasuries in the highest rated and most liquid bond market in the world, despite yields hovering near multi-year lows. We believe the relative valuation opportunity of investing in U.S. Treasuries has offset global investors' concerns about currency hedging costs, resulting in increased buying pressure, particularly in longer-dated securities. In turn, this dynamic has led to yield curve inversion in recent months **[Figure 1]**.

There are forces that could stop yields' spiral downwards. We believe at least 50 basis points (0.50%) in Fed rate cuts could be enough to quell fear in global investors and lessen the rush into longer-dated Treasuries. Over the long term, the U.S. Treasury Department will need to increase the U.S. debt supply to finance an anticipated budget deficit of about $1 trillion. Eventually, investors could demand higher yields to compensate for the extra risk.

YIELD CURVE SIGNALS

We recognize the danger of printing these words, but the current environment is *profoundly unique.* Typically, economic cycles end as inflation climbs, and the Fed responds by tightening policy, leading short-term rates to increase faster than longer-term rates, inverting the yield curve, and portending recession. The present situation involves falling commodity prices, below-target inflation, an accommodative Fed, and a firm U.S. dollar. A variety of geopolitical risks have pushed "safe haven" investors into Treasuries, despite sound fundamentals and the rising budget deficit. Consequently, the current yield curve inversion is characterized by long-term rates falling faster than short-term rates, increasing investor fears of imminent recession.

In the last three economic expansions, the U.S. economy peaked about a year after the 2-year and 10-year yield spread inverted for 90 days straight. Since the spread between the 10-year Treasury and 2-year Treasury yield has been negative only occasionally over the past few weeks, we suspect the message really is that Fed policy is too tight for current trade uncertainty. A persistent and extended inversion, however, would send a darker message about expected economic activity.

Of course, after a record expansion, we are bound to have recession sometime. Right now, economic fundamentals suggests the consumer remains sound, and any clarity on trade potentially can boost business investment, possibly supporting productivity growth and elongating the expansion.

However, prolonged trade uncertainty and a potentially rancorous U.S. election campaign leads us to wager a one-in-three chance that businesses and consumers decide to "sit this one out" in the fourth quarter of 2020 and the first quarter of 2021.

CONCLUSION

We've lowered our 10-year yield forecast to 1.75–2%. We still believe the 10-year yield's fair value is higher than these levels, but the combination of trade uncertainty, geopolitical risks, and global monetary policy could keep enticing fixed income investors into Treasuries. For fixed income allocations, we continue to emphasize a blend of high-quality intermediate bonds in tactically oriented portfolios. Treasuries look richly valued here, but investment-grade corporate bonds look attractive given U.S. company strength, and mortgage-backed securities could act as a diversification source for yields for suitable investors.

NOTE OF REFERENCE

As we announced in our August 19 *Weekly Market Commentary: Tweaking Forecasts*, we lowered our 2019 projections for U.S. gross domestic product (GDP), the 10-year U.S. Treasury yield, and S&P 500 Index operating earnings, and introduced preliminary 2020 forecasts. We're covering these changes in depth over the course of three weeks. Last week, we addressed our reasoning for lowering our U.S. GDP forecast in *Weekly Market Commentary: LPL's U.S. Real GDP Forecast Change*, and this week we covered the 10-year yield forecast. Next week, we'll highlight our thoughts on corporate profits.

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 referenced is historical and is no guarantee of future results.

The economic forecasts set forth in this material may not develop as predicted.

Investing involves risks including possible loss of principal. No investment strategy or risk management technique can guarantee return or eliminate risk in all market environments.

All indexes are unmanaged 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.

Because of its narrow focus, specialty sector investing, such as healthcare, financials, or energy, will be subject to greater volatility than investing more broadly across many sectors and companies.
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.
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. Mortgage backed securities are subject to credit, default, prepayment, extension, market and interest rate risk.
All information is believed to be from reliable sources; however LPL Financial makes no representation as to its completeness or accuracy.

DEFINITIONS

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.

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 three-month, two-year, five-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.

INDEX DESCRIPTIONS

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.