LAURA MOSSAKOWSKI, LLC
FINANCIAL PLANNING FOR WOMEN AND THEIR FAMILIES

BOND MARKET PERSPECTIVES

Major News and Themes Driving Fixed Income Markets

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Key Takeaways

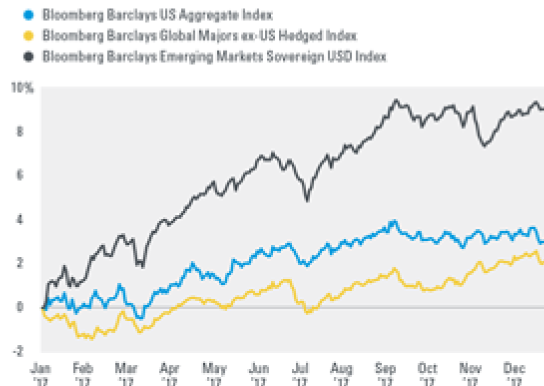
- Dollar weakness in 2017 helped propel unhedged foreign developed bonds and U.S. dollar-denominated EMD to strong performance.
- Rising rates, continued economic growth, and potential moderate U.S. dollar gains may pressure foreign bonds in 2018.
- We believe that U.S. debt, with its higher yield and lack of currency risk, may be a better option for suitable domestic investors in 2018.

A Global View on Fixed Income

Even though U.S. yields remain low by historical standards, they are attractive versus their high-quality developed market peers. However, this doesn't mean that U.S. investors should ignore opportunities in foreign bond markets. Similar to our forecast for U.S. bonds, we expect that rising interest rates and fading central bank stimulus are likely to put pressure on foreign developed bonds in 2018.* Emerging market debt (EMD), which generally pays higher rates of interest, and in many cases are issued by countries with higher rates of gross domestic product growth and lower debt levels than many developed nations, may have a brighter return outlook, though valuations remain on the expensive side of recent history.

A GLOBAL LOOK BACK AT 2017

Dollar weakness in 2017 led to strong performance for unhedged foreign bonds, with the asset class gaining 8.8% as measured by the Bloomberg Barclays Global Majors ex-US Unhedged Index, even as rates moved marginally higher over the course of the year in many countries. Hedged returns for the same index, which take out the impact of sometimes volatile currency movements, were much more subdued at 2.1% [Figure 1].



EM bonds, however, were a bright spot in 2017. The asset class hit some headwinds late in 2016 as the U.S. election stoked fears of a trade war. However, this outcome didn't materialize, and higher yields and the benefit of a weaker dollar combined to propel this market higher by 9.3% in 2017 (as measured by the Bloomberg Barclays Emerging Markets Sovereign Index).

DEVELOPED MARKETS UNDER PRESSURE

Similar to our forecast for domestic bonds, we expect high-quality foreign bonds to come under pressure in 2018. A gradual move toward less stimulus from global central banks, combined with continued economic growth, may put upward pressure on rates in foreign developed markets. This would likely translate to lower prices for high-quality sovereign fixed income securities. Other high-quality sectors, such as foreign corporate bonds, could see similar pressures as the European Central Bank (ECB) slows purchases not only in sovereign bonds, but also in corporate bonds, where it has purchased an average of 7.8 billion euros per month since June 2016 under its Corporate Sector Purchase Program (CSPP).

Unhedged foreign bonds benefited from dollar weakness in 2017, but our expectation of potential modest upward pressure on the dollar, as laid out in our Outlook 2018, could mean that currency movements become a drag on unhedged foreign bonds, potentially causing them to underperform their hedged counterparts.

CAN EMERGING MARKETS REPEAT 2017 STRENGTH?

We expect that EMD's attractive yield (4.95% according to the Bloomberg Barclays Emerging Markets Sovereign USD Index as of 1/10/18) may help sustain investor interest in the asset class in 2018, though the interest rate sensitivity of the asset class (duration of 7.3 as of the same date) could be a headwind as we anticipate rates to rise gradually over the course of the year. Additionally, valuations are stretched relative to history, with an option-adjusted spread (OAS) of just 2.7% over comparable Treasuries. This is the lowest OAS since May 2013, though it is possible spreads could compress further, as they remain above levels seen during the 2002-2007 expansion. Dollar-denominated EMD debt could also be hurt if our forecast for moderate dollar strength is accurate (given that it would be more expensive for foreign governments to buy the dollars that they would use to pay back the debt), though strong growth and debt levels that are in some cases lower than their developed nation counterparts should mean any potential pressures from currency fluctuations remain manageable for countries that are impacted.

CONCLUSION

EMD's more attractive yield and slightly lower interest rate risk could help the asset class outperform its foreign developed market counterparts in 2018, though we don't expect a repeat of strong 2017 performance given valuations that are on the expensive side of recent history. As outlined in our *Outlook 2018*, we expect that a gradual rise in interest rates, driven by continued global growth and reductions in central bank stimulus, could put pressure on foreign bonds overall in 2018. Given these factors, we continue to believe that the higher yields of U.S. bonds may offer more value for appropriate domestic investors.

**As noted in Outlook 2018: Return of the Business Cycle, LPL Research forecasts flat to low-single-digit returns for the Bloomberg Barclays U.S. Aggregate Bond Index, based on its expectations for a gradual pickup in interest rates across the yield curve. LPL Research also expects the 10-year Treasury yield to end 2018 in the 2.75-3.25% range, based on its expectations for a modest pickup in growth and inflation.*

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.

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.

Emerging market debt portfolios invest primarily in sovereigns, agencies, local issues, and corporate debt of emerging markets in the following regions: Americas, Europe, Middle East, Africa, and Asia.

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.

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.

The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged.

Option-Adjusted Spreads (OAS) represent the difference between the index yield and the yield of a comparable maturity Treasury. The OAS can be used to measure the risk levels markets are placing on high-yield bonds.

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.

Duration is a measure of the sensitivity of the price (the value of principal) of a fixed-income investment to a change in interest rates. It is expressed as a number of years. Rising interest rates mean falling bond prices, while declining interest rates mean rising bond prices. The bigger the duration number, the greater the interest-rate risk or reward for bond prices.

INDEX DESCRIPTIONS

The Bloomberg Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

The Bloomberg Barclays Capital Emerging Markets Sovereign Index (USD) measures the investment return of U.S. dollar-denominated bonds issued by governments of emerging market countries.

Bloomberg Barclays Global Majors ex US Index is an index tracking government bonds issued by Australia, Belgium, Canada, Denmark, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, the United Kingdom and the United States.

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