LPL RESEARCH

BOND MARKET PERSPECTIVES

October 10 2017

STACKING UP GLOBAL RATES

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KEY TAKEAWAYS

U.S. yields have moved higher in recent weeks, buoyed by dealmaking in Washington, D.C. and central bank actions.

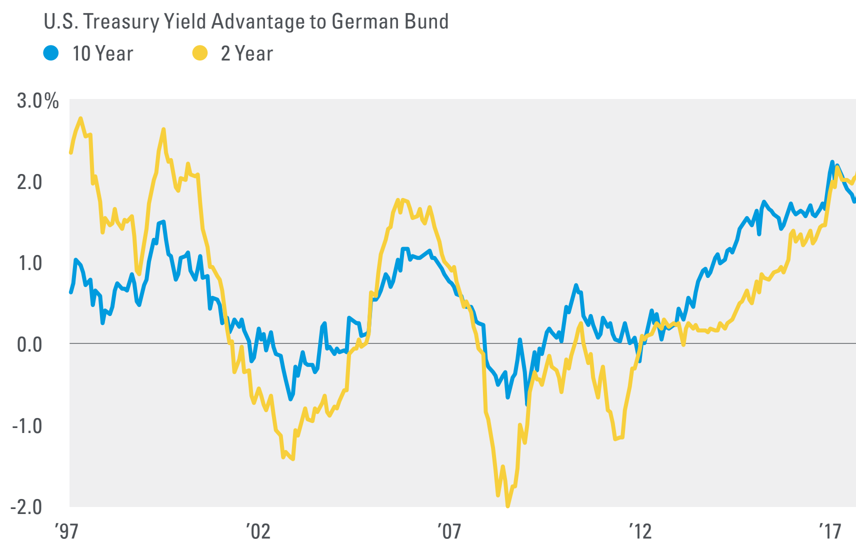
Foreign yields have also moved higher, though for the most part, they have trailed U.S. yields.

U.S. Treasuries retain a significant yield advantage relative to other major developed nations, which may help drive continued foreign demand for U.S. bonds.

Both short- and long-term Treasury yields have seen a sustained move higher since the 10-year Treasury hit year-to-date lows on September 7. A surprise debt ceiling deal between President Trump and Democratic leaders led to an initial upward move in rates. And the Federal Reserve's (Fed) announcement of the beginning of its balance sheet normalization program, as well as the continued possibility of a December rate hike, helped both short- and long-term U.S. rates move higher. Rates have made similar directional moves in many developed countries since the beginning of September, though only two other G7* nations have had rate moves that exceeded the magnitude of the yield increase in Treasuries.

Figure 1 shows the 2- and 10-year Treasury yield advantage to similar maturity German Bunds. The latest move higher in the U.S. 10-year rate has led to one of the larger moves versus the 10-year Bund since April. Though the spread remains below the 25-year+ highs seen last December, it remains elevated by historical standards. Even more interesting is the 2-year Treasury yield advantage.

1 THE U.S. TREASURY'S YIELD ADVANTAGE TO THE GERMAN BUND REMAINS ELEVATED



Source: LPL Research, Bloomberg 10/09/17

Performance is historical and no guarantee of future results.

Yield spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread (yield advantage), the greater the difference between the yields offered by each instrument.

*A term used to refer to government bonds issued by a nation in the Group of Seven (G7). A G7 bond is considered relatively less risky than bonds issued by nations outside of the G7. The G7 nations are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States. All these nations are considered industrialized and developed countries.

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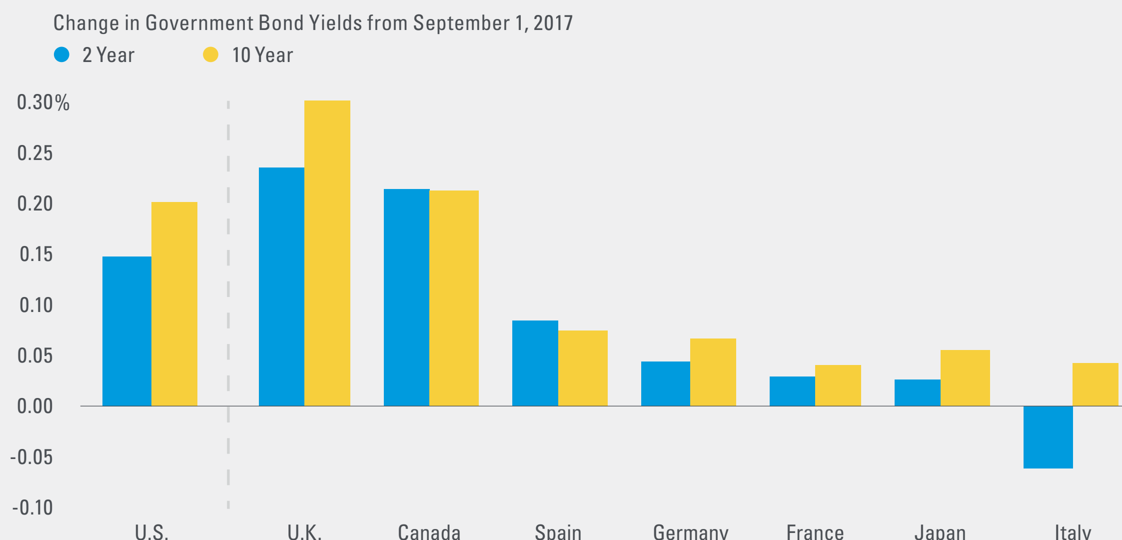
The disparity in monetary policy between major central banks, with the Fed tightening policy and the European Central Bank (ECB) continuing to ease (though the amount of easing may be lowered later this year), has led the 2-year Treasury advantage to the Bund to a 17-year high.

WHAT ABOUT OTHER DEVELOPED NATIONS?

We continue to believe that low overseas rates will be a factor that helps keep U.S. rates lower than they otherwise would be in the near term, as foreign demand for Treasuries may help support prices. We often discuss the Treasury's yield advantage to German and Japanese bonds, but U.S. debt also maintains a yield advantage to many other developed nations. In fact, the only G7 nation that has a higher 2-year yield than the United States is Canada, largely due to strong recent economic growth and expectations of additional tightening from the Bank of Canada (BOC).

The relationship between the recent move in U.S. rates and moves in other major developed nations is shown in Figure 2. The United Kingdom (U.K.) has actually seen the strongest move in rates since the beginning of September, though this move is largely related to Brexit. The U.K. economy began to see signs of rising inflation, as the pound had been depreciating versus the euro since May. The depreciation started to reverse course in late August as speculation of a rate hike from the Bank of England (BOE) started to increase, though depreciation started again last week as the potential for a leadership shakeup in the ruling Conservative party started to emerge. The BOE held steady on rates during its September meeting, but expectations remain high for a rate hike in the near future, which has helped keep short-term rates elevated. Questions related to British Prime Minster Theresa May's leadership may also be a factor in the move, though the danger of a leadership reshuffle seems to have decreased somewhat over the weekend.

2 THE RECENT MOVE IN U.S. RATES WAS LARGER THAN THOSE SEEN IN MANY OTHER DEVELOPED NATIONS



Source: LPL Research, Bloomberg 10/09/17

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International debt securities involves 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.

Canada has also seen a significant rise in yields recently. The source of this move has been better than expected economic growth and a related expectation that the BOC may continue to tighten policy. Second quarter gross domestic product (GDP) growth clocked in at 4.5%, well above the 3.7% expected by economists, as household spending surprised to the upside. The BOC raised rates in July, and again in September, but the latest economic data suggest that another rate hike may be possible in the near future, with the Bloomberg World Interest Rate Probability model showing a 63% chance of a hike in December.

Although subdued relative to some other nations, the recent move in Spanish yields is also worth discussing. The economic environment in Spain has been showing signs of improvement recently. Unemployment has been steadily dropping from 25% a couple of years ago to 17% most recently, while austerity policies coupled with GDP growth have started to flatten out the country's debt growth relative to GDP in recent years. However, Spain has been back in the news recently as the impacts of a contentious Catalonia independence vote have made headlines. This situation has raised concerns that the budding recovery could be impacted, and has led investors to demand higher yields for Spanish debt.

CONCLUSION

It is important to keep an eye on what is happening overseas given the interconnected nature of global financial markets. However, the main takeaway from a U.S. perspective is that the recent move higher in U.S. rates, contrary to some of the moves earlier this year, has been driven by U.S. factors, including an unexpected political deal and the potential for a more hawkish Fed. This move has increased the yield advantage that Treasuries enjoy relative to many other developed nations, and may lead to continued foreign demand for higher-yielding, relatively low-risk U.S. sovereign debt, keeping U.S. rates lower than they otherwise would be. ■

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