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SPREADS SIGNAL STABILITY

John Lynch *Chief Investment Strategist, LPL Financial*

Colin Allen, CFA *Assistant Vice President, LPL Financial*

KEY TAKEAWAYS

Spreads can be a useful measure of investor concern or optimism.

Surveying an array of spreads can give investors a broad gauge of market sentiment.

Some widening spread levels that concerned us recently have paused or even reversed.

Spreads across various sectors of fixed income are signaling that areas of recent stress are receding, a positive omen for bonds and stocks alike.

Spreads can be generally defined as the difference between the yield of a security or index relative to another, lower-risk, comparable maturity security or index, and can be an indicator of market concern or optimism. For instance, if investors are enthused about economic conditions and believe default rates will be low moving forward, they will demand less of a premium (relative to very low risk assets like U.S. Treasuries) in order to take on the risk of lower-rated and higher-risk segments of fixed income. Surveying the landscape of spreads can give us a good baseline of information about investors' perceptions of risks moving forward.

TAKING STOCK OF SPREADS

INVESTMENT-GRADE CORPORATES

One area where we saw some stress was in the investment-grade (IG) corporate bond market, where spreads had widened to six-month highs fairly quickly since the beginning of February 2018. This weighed on IG corporate returns, making them the worst performing sector in fixed income during the first quarter of this year. While spreads in high-yield bonds also widened, the move in IG corporates outpaced the move of lower-quality fixed income. Much of the reason for that disconnect was an elevated supply of corporate debt. Just as Treasury yields were recently pressured higher at shorter maturities because of increased Treasury supply, pent-up IG supply—on hold since late 2017 due to uncertainty surrounding the new tax plan—was released into the corporate bond market. Since the passage of the tax plan, supply has increased and credit spreads have widened.

We remain constructive on IG corporates due to the incremental yield over Treasuries and the solid ongoing backdrop for the global economy and corporate America specifically. We have seen the widening of IG corporates subside recently, holding steady near 1.1% and even partially retracing below that level.

LIBOR-OIS

The spread between the three-month London Interbank Offering Rate (LIBOR) and the three-month Overnight Indexed Swap (OIS) recently widened to its highest level since 2008. The three-month LIBOR is a good proxy for interbank lending, as it tracks the rate at which banks are willing to lend money to each other. OIS uses an overnight index rate, such as the overnight fed funds rate, and thus is a good proxy for central bank rates. Consequently, the spread between the two can be seen as an indicator of credit concerns within the banking system, and a spread increase could indicate that banks are requiring higher interest rates on peer loans.

Its recent sharp increase had investors understandably concerned. We identified three main reasons for the increase:

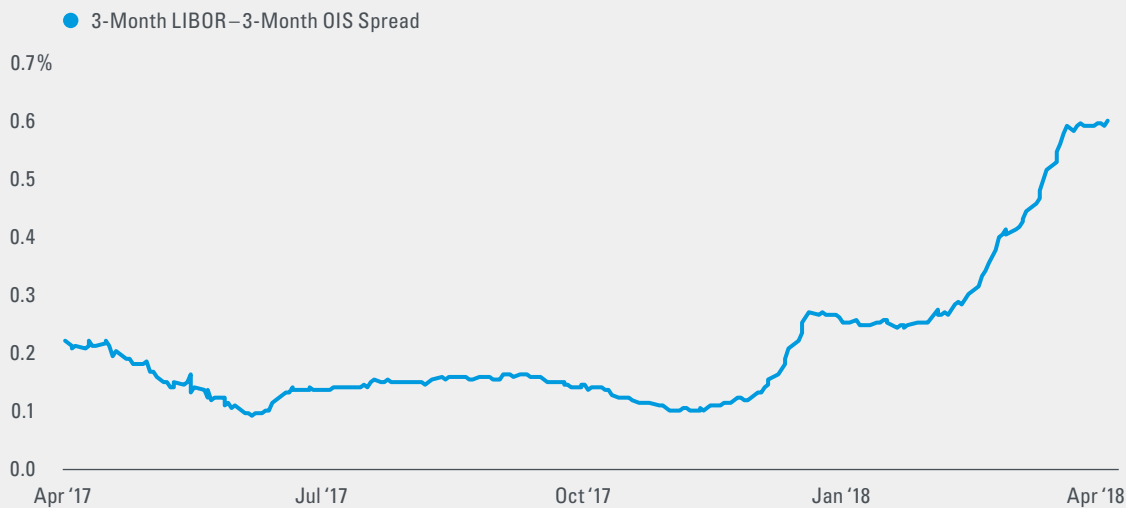
1. A surge of Treasury issuance (which pushed up borrowing rates for the U.S. Treasury and thus other borrowers).
2. Repatriation of overseas cash back to the United States taking a buyer out of the market.
3. The Federal Reserve's (Fed) balance sheet unwind (letting maturing bonds purchased through quantitative easing roll off of its balance sheet without being reinvested) taking liquidity out of the market.

In our recent commentary on this topic ("[LIBOR-OIS Spread Widening: What Lies Beneath?](#)"), we wrote that the widening of this spread could potentially subside in April, as Treasury issuance waned. That has since happened [Figure 1], signaling that the stress of this indicator may be on hold for now, limiting its potential to create other problems if short-term corporate borrowing rates had continued to notch higher.

MORTGAGE-BACKED SECURITIES

Spreads of mortgage-backed securities over comparable maturity Treasuries are widening, but at a

1 LIBOR-OIS HAS MODERATED SINCE LATE MARCH



Source: LPL Research, Bloomberg 04/06/18

Performance is historical and no guarantee of future results.

The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The three-month Overnight Indexed Swap (OIS) rate tracks the overnight effective fed funds rate.

While the fed funds contracts track to the average effective fed funds rate over the course of a calendar month, the three-month OIS contracts track the compounded fed funds rate over a three-month period.

very moderate pace. Like the LIBOR-OIS spread, this is also impacted by the roll off of the Fed's balance sheet. Given the pace of balance sheet run-off, this moderate widening is within our expectations for market behavior. We do not see the current widening of spreads to be indicative of tighter monetary conditions or some other negative event.

EMERGING MARKET DEBT

Emerging market debt (EMD) spreads had also widened, but have moved sideways recently as equity volatility has moderated. During the first quarter, not only was EMD hindered by rising rates and equity market volatility, it was also impacted by rising concerns of protectionism and a potential trade war. Trade disputes remain a critical concern for EMD, which is an important risk worth noting within the asset class.

CONCLUSION

Many spread indicators we have written about recently have been mildly concerning and worthy of continued scrutiny. This update has shown that many of those metrics have stabilized, if not improved, corroborating our view of solid fundamentals underlying the global economy. While they certainly warrant ongoing attention, we maintain our belief that credit markets are poised for stability over the remainder of the year, absent any unforeseen events. In order to fulfill fixed income's mandate as an equity risk ballast, we think investors should consider retaining a diversified allocation to high-quality fixed income, with slightly below-benchmark interest rate sensitivity, and allocations to lower-quality fixed income, like bank loans or high yield, employed at the margins for suitable investors. ■

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.

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.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate, and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity, and redemption features.

Mortgage-backed securities are subject to credit, default risk, prepayment risk (that acts much like call risk when you get your principal back sooner than the stated maturity), extension risk, the opposite of prepayment risk, and interest rate risk.

DEFINITIONS

The London Interbank Offered Rate (LIBOR) is an interest rate at which banks can borrow funds, in marketable size, from other banks in the London interbank market. The LIBOR is fixed on a daily basis by the British Bankers' Association. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans with maturities between overnight and one full year.

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.

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