Weekly Market Commentary

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Is the Bond Market Worried About Inflation?

The Federal Reserve (Fed) cut interest rates last September and, to date, the central bank has lowered rates by 1%. But over the same period, long-term Treasury yields are higher by 1% (per the 10-year Treasury yield). Does that mean bond investors are worried about inflationary pressures reigniting, particularly with tariffs and a pro-growth policy agenda under the new Trump presidency? Not yet at least. The bond market is expecting inflationary pressures to be higher than the low inflation regime experienced pre-COVID-19, but inflation expectations are not necessarily unanchored, which is good news for the Fed. And for those investors worried that inflationary pressures could reignite, Treasury Inflation-Protected Securities (TIPS) could be a good addition to portfolios to hedge potential inflation shocks.

After enduring the most aggressive rate-hiking cycle in decades, fixed income investors were likely thinking it would be an easy road to lower yields/higher prices once the Fed started cutting interest rates. Unfortunately, that hasn't happened. In fact, the opposite has happened. Since the Fed started cutting rates last September, the fed funds rate is lower by 1%, but at the same time, the 10-year Treasury yield is higher by nearly 1%. Only in 1981, at the height of the highest inflationary pressures ever here in the U.S., did the 10-year yield move higher than the recent move during a Fed rate-cutting campaign. During rate-cutting campaigns, long-term yields tend to drop — not rise. Reasons behind the move are plentiful, with more resilient economic growth, concerns about inflation, and Treasury supply/demand dynamics all reasons why Treasury yields are higher. But looking at what markets are pricing in for inflation risks, inflation reigniting is only contributing roughly a third of the move higher in interest rates, with non-inflationary reasons contributing the rest.

Market-Implied Inflation Expectations Remain Anchored

As fixed income investors have seen over the past few years, inflation is disruptive to many fixed income markets. Not only does inflation eat away at the fixed nature of bond payments, it also usually comes with interest rate hikes from the Fed. Recent inflation data continues to show progress, albeit slower than many had expected. But inflation data (per the year-over-year Consumer Price Index) remains above the Fed's 2% target and has remained above that target for 46 months and counting. Now, with the Trump administration's plans to levy tariffs, potentially universally, and implement a number of pro-growth policies, bond investors may be concerned that we could be headed for another round of elevated inflation pressures. The bond market isn't seeing it that way, at least not right now.

Treasury securities can be broken out by inflation and growth expectations (along with a term premium, which is the additional compensation investors demand for owning longer-maturity Treasury securities). The inflation component can be captured by comparing the difference between nominal Treasury securities to TIPS. The difference is commonly referred to as "breakevens" and is used to measure market-implied inflation expectations. (Side note: the difference between nominal Treasuries and TIPS is called "breakeven" because that is the inflation rate necessary for an investor to be indifferent between owning nominal Treasuries or TIPS. If an investor thinks that inflation will be above the breakeven rate, the investor will buy TIPS and vice versa. More on this later.) Market-implied inflation expectations, while elevated relative to the low inflation environment experienced pre-COVID-19, suggest inflation will stay around the Fed's 2% target for the next 10-years — more like the environment before the Global Financial Crisis in 2008. The bond market is not currently pricing in runaway inflation pressures that would cause the Fed to hike interest rates. Moreover, the pre-COVID-19 period was characterized by generally lower growth and inflation (and low interest rates) relative to previous decades. That period may be behind us, but of the

1% increase in the 10-year Treasury yield since the Fed started cutting rates, only around 0.30% is due to higher inflation concerns.

Markets Expect Inflationary Pressures Similar to the Pre-Global Financial Crisis Period

Source: LPL Research, Bloomberg, 01/23/25
Disclosures: All indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

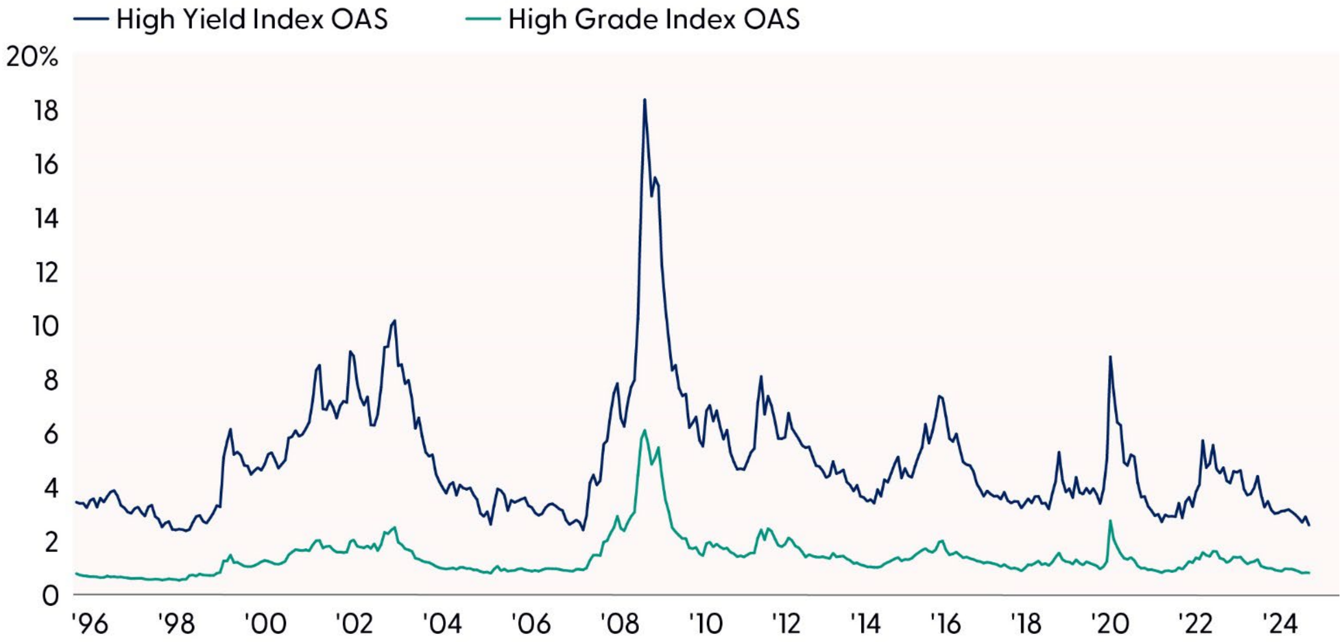
Credit Markets Show No Signs of Inflation Concerns

As mentioned, many fixed income markets are negatively impacted by inflation, and corporate credit markets are no different. Moreover, the corporate credit markets can, at times, act like a canary in the economic coalmine. The return distribution for credit investors is asymmetrical, which means the potential for losses can be magnitudes larger than the potential for gains. So, credit markets tend to react quickly when economic conditions or corporate credit conditions start to deteriorate.

Option-adjusted spreads (OAS) represent the additional compensation for holding risky debt and, generally speaking, corporate credit OAS is a good barometer for the overall health of the economy. So, the fact that both high grade and high yield company credit OAS have remained close to secular tights, unlike during 2022 when spreads widened on the back of higher inflationary pressures, suggests the corporate sector is in good shape and credit markets aren't overly concerned about inflation reaccelerating. Additionally, despite volatility in the Treasury markets, we haven't seen the same volatility in corporate credit spreads, which is a good sign that the economy broadly is still in pretty good shape.

Now, to be fair, with the increase in Treasury yields of late, benchmark yields for both high grade and high yield corporate credit have increased from recent lows, resulting in, primarily, institutional investors taking advantage of the recent back-up in yields, which is keeping OAS levels contained. Nonetheless, corporate credit markets remain unfazed about the prospects of higher inflation or really anything at this point.

Credit Markets Aren't Concerned About...Anything



Source: LPL Research, Bloomberg, 01/23/25
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What's the Fed to Do?

The Fed concludes its two-day meeting on Wednesday, January 29, where it is highly unlikely it will change its interest rate policy — markets have priced in only a 0.5% probability of a cut. As such, markets will likely be more focused on the press conference held after the meeting than the actual statement itself. The last Fed meeting (December 18, 2024) surprised markets on a number of levels, with the combination of several dissents to the last rate cut (both formally and informally), a slower projection of inflation returning to target, forecasts for fewer cuts to come, and Fed Chair Jerome Powell's characterization of rates as "significantly closer to neutral" as evidenced by the sharp repricing across asset classes following the meeting. Given the lack of data releases and no real expectation for a rate cut this time around, markets may not react as volatile as they did for the December meeting, barring a surprise.

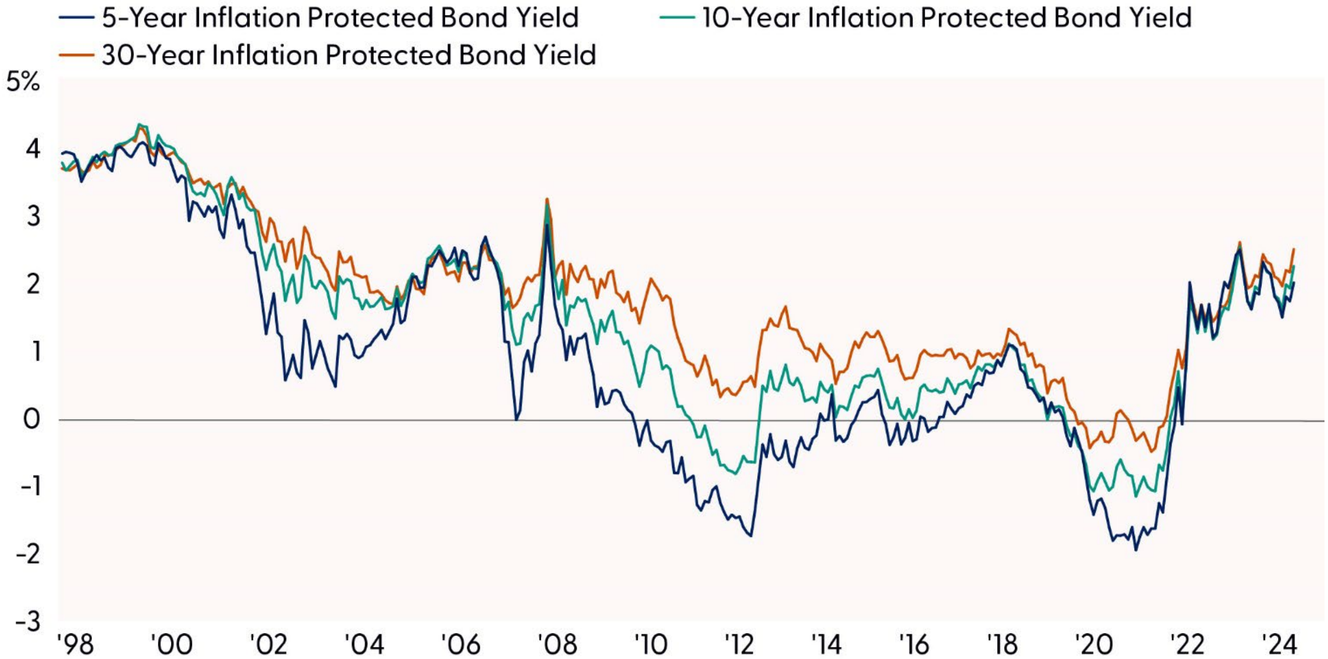
And with inflation still above the Fed's target, we think the Fed could be on an extended pause, perhaps until the summer months. We think there is a good chance the Fed will cut interest rates a few more times this year, but absent economic data that shows the economy is headed for a recession (not our base case), it's likely the Fed could be close to the end of its rate-cutting campaign. That will likely keep intermediate and longer-term interest rates above our year-end 10-Year Treasury target of 3.75–4.25%. And while nominal Treasuries may not fall much from current levels, investors could look to TIPS as a way to still take advantage of a bond market not overly concerned about inflation risks.

Tips on TIPS

As mentioned earlier, the bond market is rather sanguine about a sudden spike in inflationary pressures. But what if markets are wrong and investors want to add a potential inflation hedge to portfolios? TIPS are Treasury securities with principal and interest payments adjusted for inflation. Unlike other Treasury securities, where the principal is fixed, the principal of TIPS can go up or down over its term based upon realized inflation. So, when TIPS mature, if the principal is higher than the original amount (inflation was higher than expected), you get the increased amount. If the principal is equal to or lower than the original amount (inflation came in in-line or below expectations), you get the original amount. Since these securities are government guaranteed, TIPS investors who hold the individual bonds to maturity receive, at a minimum, the original investment back plus coupons (paid semiannually), but could get more than the original investment if inflation surprises to the upside.

TIPS yields, also known as real yields since these yields are more driven by growth expectations, have increased recently as well. In fact, most of the increase in Treasury yields has come from better economic growth expectations pushing real yields higher as well. And real yields remain above longer-term averages. Real yields, particularly at these levels, represent attractive inflation-adjusted returns. Remember, TIPS provide inflation-adjusted returns, so if inflation does spike higher, TIPS will account for that inflation spike if held to maturity. A caveat though is that TIPS are interest rate sensitive, so if the Fed has to *hike* interest rates to slow inflationary pressures (not our base case), the mark to market value of TIPS will decline as well. But investors will receive full, inflation-adjusted principal payments upon maturity.

Real Yields Remain Above Longer-Term Averages



Source: LPL Research, Bloomberg, 01/23/25
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Conclusion

The recent move higher in Treasury yields has been unusual but not unprecedented. In fact, the rise in longer-term interest rates can really be thought of as a normalization of the Treasury yield curve. The U.S. Treasury yield curve had been inverted (meaning shorter-maturity securities had a higher yield than longer-maturity yields, which is historically infrequent) for years, so the move higher in yields represents an economic environment that has outperformed expectations and is no longer pricing in the prospects of recession. That is, the Treasury yield curve is moving back to its normal upward-sloping shape. While inflation expectations have increased recently, the bond market isn't convinced that a second wave of inflation pressures is imminent. Better growth and the potential for elevated levels of Treasury supply coming to market have been the primary reasons yields have moved higher. But if the bond market is wrong, investors could look to TIPS to provide an inflation hedge for portfolios.

Asset Allocation Insights

LPL's Strategic and Tactical Asset Allocation Committee (STAAC) maintains its tactical neutral stance on equities, with a preference for the U.S., a slight tilt toward growth, and benchmark-like exposure across the market capitalization spectrum. However, we do not rule out the possibility of short-term weakness as sentiment remains stretched and a lot of good news is priced into markets, even as geopolitical threats escalate. Within fixed income, the STAAC continues to hold an overweight tilt in preferred securities as valuations remain attractive. However, the risk/reward for core bond sectors (U.S. Treasury, agency mortgage-backed securities, investment-grade corporates) is more attractive than plus sectors. In our view, adding duration isn't attractive at current levels, and the STAAC remains neutral relative to our benchmarks.

Important Disclosures

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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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.

The PE ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher PE ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower PE ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

All index data from FactSet or Bloomberg.