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Insights from Brett Wander

Chief Investment Officer, Fixed Income

Perspective on global economic and fixed income developments

Bond yields: Lower for longer

Fall 2017

Unexpected events have been commonplace in 2017, with 2018 likely to be a repeat in several ways. Changes in Federal Reserve (Fed) leadership, proposed changes in federal tax policies, an unexpected standoff between an ever-tighter jobs market and lackluster inflation, and a second year of unprecedented presidential politics in the U.S. are a few examples of what awaits the markets next year. Where will intermediate- and long-term bond yields wind up in response to that environment? We think your clients might be quite surprised by how low U.S. bond yields could remain next year, and we don't expect longer-term bond yields to skyrocket anytime soon.

Reality check: What the Fed can, and cannot do

Heading into 2017, the Fed forecasted three interest rate hikes for this year. Unlike their forecasts heading into 2015 and 2016, this year's forecast has unexpectedly been right on the mark. Two rate hikes are behind us, a third hike in December seems all but guaranteed, and more are forecasted for 2018. Those changes have lifted the federal funds rate by a full percentage point since late 2015. Yet while the Fed is the 800-pound gorilla in the room regarding overnight lending rates, their control over longer-term rates is extremely limited.

Key takeaways:

- Longer-term bond yields don't have to rise just because the Fed raises rates.
- The results of the Fed's recent series of rate hikes prove that growth and inflation expectations are far more important for bonds.
- The Fed's balance sheet reductions shouldn't put much pressure on longer-term rates.
- If your clients think yields are low in the U.S., they should take a look at Group of Seven (G7) bond yields.
- When planning for 2018, consider reminding your clients about the critical role that high-quality bonds can play in a diversified portfolio.

Remarkably resilient longer-term bond yields

For any of your clients holding fast to the belief that Fed rate hikes have to drive up longer-term bond yields, the chart below should provide a wake-up call. The chart shows the history of the 10-year Treasury—a security that has a huge influence on a wide variety of interest rates—and where its yield has ranged since 2015.

> Even more remarkable still, 10-year Treasury yields are up only about 10 basis points from when the Fed began their efforts to normalize rates in mid-December 2015. Surprise!

As the chart reveals, yields on 10-year Treasuries recently traded around 2.40%. So in spite of the 50 basis point (0.50%) hike in the federal funds rate so far this year—with another 0.25% quite likely in December, and already priced into the markets—yields on 10-year Treasuries have fallen 5 basis points from the end of 2016. Even more remarkable still, yields on 10-year Treasuries are up only about 10 basis points from when the Fed began their efforts to normalize rates in mid-December 2015, even though the federal funds rate has risen by 1.0%. Surprise!

Balance sheet reductions shouldn't pose a problem

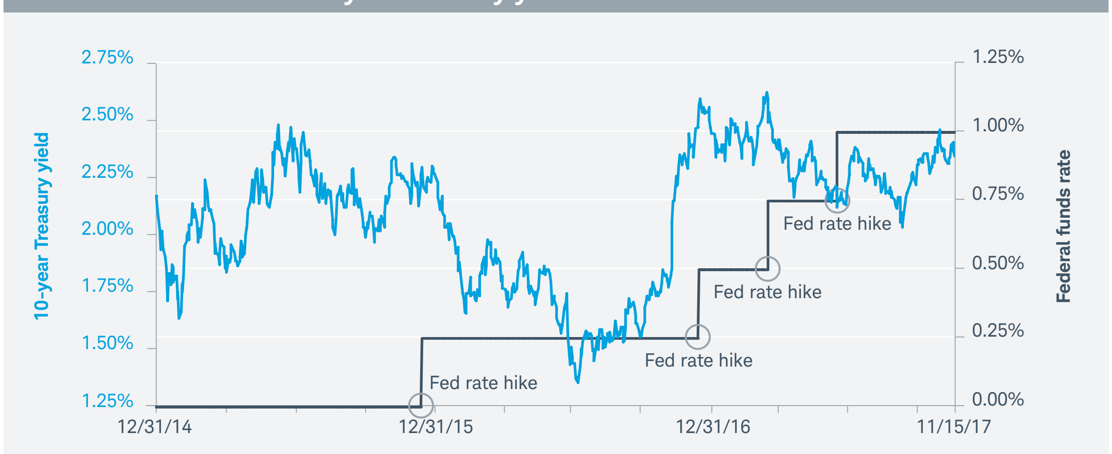
What about the Fed's efforts to reduce their balance sheet, which grew to epic proportions after three quantitative-easing programs? Doesn't this represent a key reason why longer-term rates are likely to skyrocket in 2018? Ask your clients this: "If you were the Fed, would you want to sabotage your efforts to fix the U.S. economy in the wake of the 2007–2008 financial crisis?" Certainly not, and neither does the Fed, which is why they don't plan on dumping their roughly $4.5 trillion balance sheet on the markets all at once. Doing so might not only destabilize the U.S. economy, but major economies in Europe and Asia as well. Countries in these regions hold a healthy amount of U.S. Treasuries to help manage their reserves and liquidity needs. So a sudden, huge spike in U.S. rates would have negative consequences across the globe.

Instead of an immediate, drastic downsizing of the Treasury Department's balance sheet, the Fed plans on a measured, transparent approach that should have a minimal impact on rates. By some forecasts, this reduction process could take up to four years, giving the markets plenty of time to absorb an additional $50 billion or so of Treasuries and mortgage-backed bonds each month. Current Fed Chair Janet Yellen used the phrase, "It will be like watching paint dry," in reference to the speed of the expected unwinding process. Finally, even though Yellen will step down in 2018, and the reins potentially shift to Jerome Powell as President Trump's nominee, we expect the Fed to maintain pretty much the same cautious approach that Yellen has already established.

10-year Treasury yields little changed

The Fed has raised rates by 1.0% since mid-December 2015, yet 10-year Treasury yields are up by only about 10 basis points!

Federal funds rate vs. 10-year Treasury yields



Sources: Charles Schwab Investment Management; Bloomberg; data from 12/31/14 to 11/15/17.

If your clients think that bond yields are low in the U.S., have them take a look at G7 sovereign bond yields—they're even lower!

Yields have fallen around the world...

If longer-term rates seem unlikely to rise much in 2018, are there better, more attractive opportunities overseas for higher-yielding bonds? If your clients think that bond yields are low in the U.S., have them take a look at G7 sovereign bond yields—they're even lower!

Yields on international bonds around the world fell in the wake of the global financial crisis, with the European Central Bank, Bank of Japan, Bank of England, and other major banks adopting a variety of extraordinary measures engineered to stimulate their ailing local economies. Much like efforts by the Fed, this helped drive yields lower around the world. Yet unlike the recovery that the U.S. has now enjoyed for more than eight years, some international economies are less than a year into their own post-crisis recovery periods.

So although U.S. bond yields have been rising a bit as growth prospects continue to improve, yields in other developed economies could stay low for quite some time, helping to keep a lid on U.S. rates.

...and yield spreads have contracted accordingly.

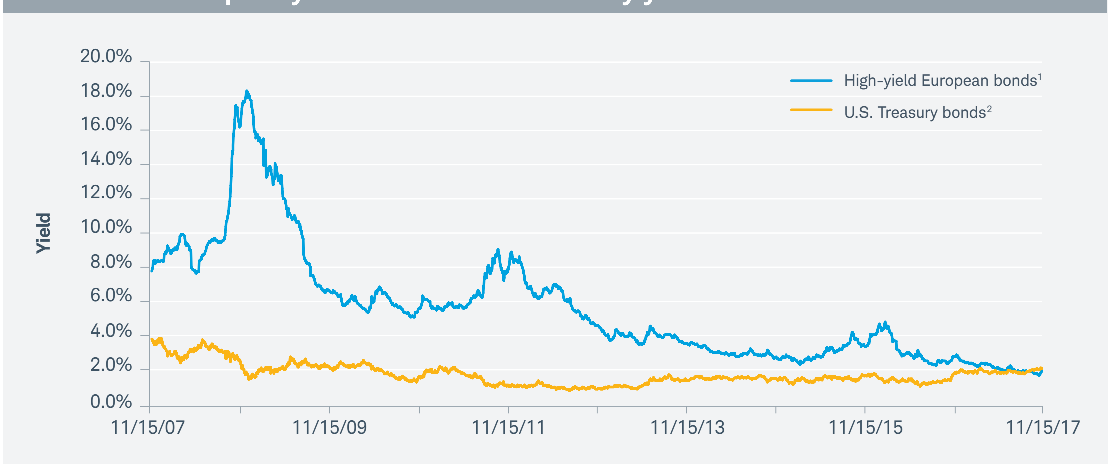
With rates generally falling around the world over the past half-dozen years or so, demand for higher-yielding alternatives to government-backed bonds has risen. The problem is that just as there's no such thing as a free lunch, there's no such thing as free yield, either. Higher yields generally require taking on increased risks. As we've discussed in the past, targeting a specific yield over the last decade would have required moving down the credit-quality spectrum consistently. Where a 5.0% yield was readily available on U.S. Treasuries a decade ago, in today's market, a similar yield target would require buying a high-yield corporate bond with a lot more credit and liquidity risk. This has caused the risk premium on high-yield corporate bonds in the U.S. to fall to its lowest levels in more than a decade.

A similar scenario has played out overseas. Amid the global stretch for additional yield, high-yield corporate bonds in Europe have watched their yields fall to what we consider unprecedented levels. So much so that yields on these securities are about the same as yields on U.S. Treasuries, the safest and most liquid bonds in the world.

The chart below illustrates this point, and moreover, shows how two bonds with nearly identical yields can have completely divergent risks. This is why we currently consider Treasuries a more compelling value than high-yield European bonds. There's just not enough potential reward for the associated risks to make them effective substitutes.

For the first time in more than a decade, yields on BB-rated European bonds are about the same as yields on U.S. Treasuries.

Low-rated European yields are near U.S. Treasury yields for the first time



Sources: Charles Schwab Investment Management; Bloomberg–data from 11/15/07 to 11/15/17.

Where do we go from here?

So what would it take for longer-term bond yields to rise in the U.S.? In the end, it's all about expectations for inflation and economic growth. Neither the Fed nor market pundits know exactly what it'll take for inflation to rise. Inflation has remained below Fed expectations in spite of job growth and oil prices once again on the rise. We don't expect to see a sudden, prolonged surge in U.S. economic growth, either. So the idea that inflation is suddenly going to spike seems pretty unrealistic.

With this backdrop in mind, what should you tell your clients? Given how much uncertainty 2018 may hold—from the political landscape, to elevated stock market valuations, to geopolitical risks—remind your clients about the crucial role that high-quality U.S. bonds can play in a well-diversified portfolio. These securities tend to perform best when stocks underperform, providing portfolio ballast when your clients need it most. Also, don't forget that longer-term rates don't have to rise just because the Fed raises rates, as recent history proved. Additionally, even though your clients may be tempted to reach for high-yield overseas bonds in hopes of getting a bit more income, Treasuries currently represent a far better risk/reward play from our perspective.

About the author

Brett Wander is Chief Investment Officer (Fixed Income) of Charles Schwab Investment Management, Inc. (CSIM), a subsidiary of The Charles Schwab Corporation. Wander joined CSIM in 2011 and is responsible for all aspects of the firm's fixed income and money market portfolios, leading a team of more than a dozen investment professionals. Over his more than 20 years of investment management experience, Wander has been intimately involved in the design, development, and oversight of a wide range of active, indexed, and alternative fixed income strategies. His expertise spans a wide range of global and domestic markets and sectors. He is a frequent industry speaker, presenting at conferences and in various media forums. He has taught MBA-level investment courses at the University of Southern California. Wander earned an MBA from the University of Chicago and a BS in system science engineering from the University of California, Los Angeles. He is a Chartered Financial Analyst® charterholder.

Brett Wander, CFA
Chief Investment Officer, Fixed Income
Charles Schwab Investment Management

Important disclosures

Past performance is no guarantee of future results.

[1] High-yield European bonds represented by the ICE BofAML BB Euro High Yield Index, which tracks the performance of EUR denominated below investment grade corporate debt publicly issued in the euro domestic or eurobond markets.

[2] U.S. Treasury bonds represented by the ICE BofAML US Treasury Index, which tracks the performance of U.S. dollar-denominated sovereign debt publicly issued by the U.S. government in its domestic market.

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