YOUR FINANCIAL FUTURE

Your Guide to Life Planning

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Bond Market Perspectives | Week of September 5, 2017

Key Takeaways

- Raising the debt ceiling is a major item on the agenda as Congress returns from their August recess today.
- While debt ceiling debates can be contentious, history can help shed light on what markets are pricing in.
- The bond market continues to price in a stalemate in the near term, though it ultimately appears to believe the ceiling will be raised.

Is The Bond Market Expecting a Debt Ceiling Fight?

Congress reconvenes today following its August recess and one of the major legislative topics that needs to be addressed is the debt ceiling. The debt ceiling refers to the legislatively mandated maximum amount of debt that the U.S. Treasury can have outstanding. The U.S. officially hit the debt ceiling (currently at $19.8 trillion) in March, and since that time the Treasury has been using "extraordinary measures," which include things like suspending the reinvestment of funds from certain Treasury securities, to allow the U.S. to pay its debts until Congress is able to raise the borrowing limit. Treasury Secretary Mnuchin has indicated that these extraordinary measures will be exhausted sometime toward the end of September, but has continually said that he is confident that the debt ceiling will be raised in time to avoid a default.

MARKET ASSUMES A DEAL, BUT IS HEDGING

Bond market participants normally demand more yield for holding longer-maturity bonds. One reason is that a longer time frame introduces more uncertainty, and may allow more time for financial problems to emerge that could make it harder for an issuer to pay principal and interest. Though this risk is generally thought of as remote for Treasury bonds, if the Treasury hits the debt limit and is unable to borrow additional funds, it could eventually end up impacting the Treasury's ability to pay investors.

Given this, one way to determine if the bond market is pricing in a debt ceiling fight is to look at the spread, or difference in yield, between short-term Treasury notes. If there is uncertainty among investors that the debt ceiling will be raised, we would expect that they would demand more yield for bonds maturing on or after the end of September. As we can see in Figure 1, the spread between 1-month and 3-month Treasury securities has declined in recent weeks. The fact that market participants are demanding more yield for 1-month Treasuries that mature near the end of September, relative to 3-month Treasuries, indicates that as a whole investors are at least somewhat concerned about a debt ceiling debate.

1 SHORT-TERM TREASURY YIELDS HAVE SHOWN SOME SIGNS OF DEBT CEILING CONCERNS

Source: LPL Research, FactSet 09/01/17

Performance is historical and no guarantee of future results.

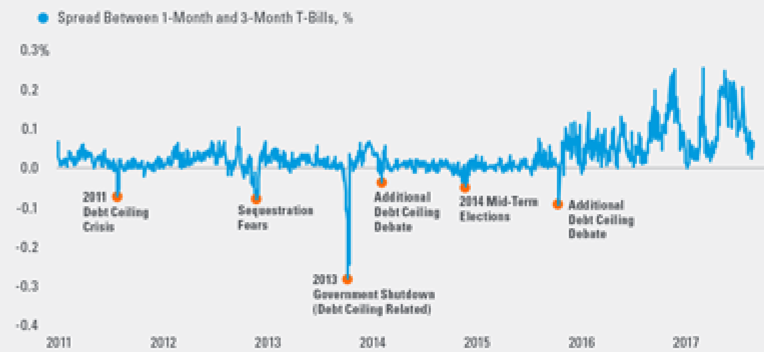
The fact that the spread between 1-and 3-month Treasuries increased slightly over the past week, could be a sign that fears are fading somewhat, perhaps on speculation that an increase in the debt ceiling could be tied to funding for relief efforts for Hurricane Harvey, making it more difficult for Congress to allow a delay. However, even after this recent increase, the spread remains below its 1-year average indicating that the bond market is still flashing some caution signs.

There is one additional sign that markets aren't pricing in a long-term debt ceiling problem. In late July the yield on the 3-month Treasury bond (which would have matured in October at that time) moved higher as debt ceiling fears began increasing. However, since that time the yield has fallen, indicating that markets may view any potential debt ceiling impasse as temporary, and continue to expect that the debt ceiling will ultimately be raised.

PAST DEBATES HAVE SHOWN A SIMILAR PATTERN

Debt ceiling debates are nothing new for markets, and looking back at history, we can see that markets have reacted in a similar fashion as they are today. Past debt ceiling debates, both major (2011--which included a credit rating downgrade by S&P) and minor (2015), have caused the yield differential between 1-and 3-month Treasuries to decrease, and even invert (meaning that the 1-month yield is higher than the 3-month). However, as Figure 2 shows, this behavior generally doesn't last long.

2 DEBT CEILING DEBATES HAVE HISTORICALLY CAUSED AN INVERSION IN THE T-BILL CURVE



Source: LPL Research, FactSet, 09/01/17

Performance is historical and no guarantee of future results.

A negative spread (inversion) indicates the 1-month Treasury yield is higher than the 3-month.

Inversion already took place in the 3- to 6-month part of the yield curve in July, but it was short-lived, again indicating that markets aren't pricing in extended uncertainty. No inversion has taken place in the 1- to 3-month part of the curve so far, though it remains a possibility. It is also important to note that short-term yields are higher today than they were in 2011, 2013, or 2015, largely due to several Federal Reserve rate hikes since the last time the debt ceiling was debated. While it could be considered problematic that Congress has made a habit of politicizing the debt ceiling, we can take some comfort in the fact that markets have been here before and have made it through.

CONCLUSION

The current debt ceiling was hit in March 2017, and while the Treasury has been able to use extraordinary measures to avoid a default since that time, they have indicated that these measures will be exhausted sometime near the end of September. With Congress back in session, the topic of the debt ceiling is likely to be front and center. Though the Treasury seems confident that the limit will be raised and there will be no impact to their ability to pay back investors, the bond market is pricing in at least some chance of a stalemate in the short term. Ultimately though, the fact that yields on longer-dated Treasury securities haven't risen indicates that markets believe that a deal can get done, and that the Treasury is likely to be able to pay investors in a timely manner, a positive for both bond and stock markets.

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.

DEFINITIONS

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, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings, and risk.

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Weekly Market Commentary | Week of September 5, 2017

HIGHLIGHTS

- Investors have understandably become increasingly concerned amid escalating North Korean threats.
- As scary as the threat may be, history suggests that stock market reactions to similar events have been short lived.
- While we are all hoping for a peaceful resolution, military conflicts do carry the potential to unify policymakers.

PUTTING THE NORTH KOREAN THREAT INTO PERSPECTIVE

Investors have become increasingly concerned about the escalating North Korean threats, and understandably so. After initially shrugging off the risk, financial markets have shown increased concern over the past several weeks as the threats have become more direct (Guam) and the range of missile tests has increased (over Japan). In the latest development over the weekend, North Korea conducted its largest nuclear test and claims to have a hydrogen bomb capable of being delivered on a long-range missile. While the future of this conflict is very much uncertain, and we are sympathetic to the potential human impact of military engagement, from a market perspective, a look back at past geopolitical and military events offers a reassuring view.

HISTORICAL MARKET PERSPECTIVE

Although responses to growing nuclear capacity are more limited in number (thankfully), we do have many historical military conflicts to consider for a sense of how stocks might react. Regardless of the circumstances, looking at history to find similar conditions or events can be helpful.

> In mid-August we recommended taking some risk off the table, due in part to geopolitical uncertainty; other considerations included seasonal factors, a lack of clear near-term positive catalysts, policy risks in Washington, D.C., the stock market's strong 2017, and near historically low volatility.

With help from our friends at Ned Davis Research, we compiled a list of notable military events dating back to World War I and then looked at how stocks performed after these events **[Figure 1]**. The market performance appears encouraging--stocks tended to react negatively on the days that the events occurred, with an average drop of about 4%; but afterwards, stocks displayed impressive resilience. Over the subsequent one-, three-, six-, and twelve-month periods, stocks have produced solid gains, on average, with gains in over 60% of the periods included. But perhaps most impressive is that the Dow Industrials were higher six months after these events 81% of the 21 occurrences, with an average gain of 10%; and over the subsequent year, stocks rose 16% on average.

Also noteworthy is how fast stocks have recouped those initial losses. In most instances, the Dow Jones Industrials Average has returned to pre-event levels within a couple of weeks or less. The primary reason why stocks have been able to shrug off most of these events, and why we think stocks may behave similarly in response to the North Korean threat, is that historically speaking, these conflicts tend not to disrupt the business cycle, which is the single most important factor in the path of stock prices over time.

1 STOCK MARKET REACTIONS TO HISTORICAL MILITARY CONFLICTS PROVIDE SOME REASSURANCE

		DJIA Performance After Event					
Event	Reaction Dates	Initial Decline During Reaction Dates	1 Month	3 Months	6 Months	12 Months	Number of Trading Days to Recoup
Exchange Closed WWI	07/22/1914–12/24/1914	-10.2	10.0	6.6	21.2	80.2	63
Germany Invades France	05/09/1940–06/22/1940	-17.1	-0.5	8.4	7.0	-5.2	1000
Pearl Harbor	12/06/1941–12/10/1941	-6.5	3.8	-2.9	-9.6	5.4	229
Korean War	06/23/1950–07/13/1950	-12.0	9.1	15.3	19.2	26.3	44
Suez Canal Crisis	10/30/1956–10/31/1956	-1.4	0.3	-0.6	3.4	-9.5	1
Cuban Missile Crisis	10/19/1962–10/27/1962	1.1	12.1	17.1	24.2	30.4	2
U.S. Bombs Cambodia	04/29/1970–05/14/1970	-7.1	0.4	3.8	13.5	36.7	69
Iranian Hostage Crisis	11/02/1979–11/07/1979	-2.7	4.7	11.1	2.3	17.0	5
U.S.S.R. Invades Afghanistan	12/24/1979–01/03/1980	-2.2	6.7	-4.0	6.8	21.0	5
Falkland Islands War	04/01/1982–05/07/1982	4.3	-8.5	-9.8	20.8	41.8	0
Beirut Bombing	10/21/1983–10/23/1983	0.0	2.1	-0.5	-6.9	-2.9	1
U.S. Invades Grenada	10/24/1983–11/07/1983	-2.7	3.9	-2.8	-3.2	2.4	4
U.S. Bombs Libya	04/14/1986–04/21/1986	2.8	-4.3	-4.1	-1.0	25.9	0
Invasion of Panama	12/15/1989–12/20/1989	-1.9	-2.7	0.3	8.0	-2.2	9
Iraq Invades Kuwait	08/02/1990–08/23/1990	-13.3	0.1	2.3	16.3	22.4	120
Gulf War	01/16/1991–01/17/1991	4.6	11.8	14.3	15.0	24.5	0
U.S. Embassy Bombings Africa	08/06/1998–08/14/1998	-1.8	-4.0	4.8	10.4	32.0	4
U.S.S. Cole Yemen Bombing	10/11/2000–10/18/2000	-4.2	6.6	6.1	6.1	-5.1	9
WTC and Pentagon Terrorist Attacks	09/10/2001–09/21/2001	-14.3	13.4	21.2	24.8	-6.7	34
War in Afghanistan	10/05/2001–10/09/2001	-0.7	5.9	11.5	12.4	-16.8	1
Iraq War	03/19/2003–05/01/2003	2.3	5.5	9.2	15.6	22.0	0
	Mean	-4.0	3.6	5.1	9.8	16.2	76
	Median	-2.2	3.9	4.8	10.4	21.0	5
	Percentage of Positive Periods	24%	76%	67%	81%	67%	

Source: LPL Research, FactSet 08/31/17

Days = Market Days

The 22, 63, 126, and 253 day rate-of-change is calculated from the last day in the reaction dates column.

The first date in the reaction dates column indicates the start of the market reaction or the trading day prior to the event.

1914 data—In 1916 a new list of 20 stocks for the DJIA was adopted and computed back to the reopening of the exchange on 12/12/1914. NDR analysis for this study adjusted the DJIA index level prior to 12/12/1914 to reflect an accurate and consistent data set. Source: The Dow Jones Averages 1885-1990, Edited by Phyllis S. Pierce.

All indexes are unmanaged and cannot be invested into directly.

Past performance is no guarantee of future results.

MORE DEFENSE SPENDING

We expect defense spending to rise as a result of heightened tensions with North Korea, though the trajectory had already been pointing higher since the November election. The North Atlantic Treaty Organization's (NATO) 2% of gross domestic product defense spending targets and President Trump's calls for other countries to increase spending have put some upward pressure on global defense spending this year. According to NATO, defense spending among European members and Canada is expected to increase more than 4% in 2017. In addition, as tensions with North Korea escalate, the odds of a preventative strike from the U.S., while still low, rise, and the need for stronger missile defense capabilities increases, pushing the defense spending trajectory even higher for the U.S. and our Asian allies. As a result, defense stocks may get a boost.

UNITY IN WASHINGTON?

Military conflicts, as unwelcomed as they may be, do bring the potential to create unity in the country and among policymakers in Washington, D.C. While it is very difficult to envision much bipartisan agreement in the current political environment, the latest U.S. security threat may make reaching a 2018 federal budget agreement easier. Defending the country from an immediate threat is something policymakers and most of their constituents on both sides can generally agree on. The devastation of Hurricane Harvey can have a similar impact, as we touch on in today's *Weekly Economic Commentary*.

CONCLUSION

A nuclear-armed North Korea is undoubtedly a scary proposition. While we hope for peaceful resolution, which we currently view as likely, during periods of uncertainty, as investors we use history to help us navigate challenging investment landscapes. In the case of this worrisome threat from a stock market perspective, history does offer some reassurance. We acknowledge that geopolitical risk may contribute to heightened near-term stock market volatility, and are always watchful for developments that may warrant a change in our asset allocation. At this point in time, LPL Research does not foresee a prolonged military conflict or sustained stock market weakness that could end the current bull market.

A special thank you to the courageous members of our military who help to keep us all safe.

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Investing in stock includes numerous specific risks including: the fluctuation of dividend, loss of principal, and potential liquidity of the investment in a falling market.

Investing in foreign and emerging markets securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical risk, and risk associated with varying accounting standards. Investing in emerging markets may accentuate these risks.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

All investing involves risk including loss of principal.

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.

The Dow Jones Industrial Average Index is comprised of U.S.-listed stocks of companies that produce other (non-transportation and non-utility) goods and services. The Dow Jones Industrial Averages are maintained by editors of The Wall Street Journal. While the stock selection process is somewhat subjective, a stock typically is added only if the company has an excellent reputation, demonstrates sustained growth, is of interest to a large number of investors and accurately represents the market sectors covered by the average. The Dow Jones averages are unique in that they are price weighted; therefore, their component weightings are affected only by changes in the stocks' prices

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While inflation has been a constant fact of life in the U.S. economy, it can be particularly damaging to retirees, many of whom are living on fixed incomes.

Inflation -- The Subtle Thief of Your Purchasing Power

American workers are laboring as diligently as ever, but they have little extra to show for their effort. Combine meager pay increases with the slow but steady effects of inflation, and it is easy to see how families are barely breaking even.

Workers have been receiving, on average, 2% pay increases for the past three years.[1] But when you adjust that increase for inflation, what's left is negligible. In April of this year, for instance, inflation-adjusted earnings rose just 0.3% from the previous year. In April 2016, wages rose 1.2% annually after inflation, and in 2015 that figure was double -- at 2.4% -- thanks to near-zero increases in the cost of consumer goods and services at that time.[1]

Ramping Up?

While inflation rose 2.2% for the 12 months ending in April, policymakers at the Federal Reserve -- the nation's central bank and overseer of our monetary system -- expect price increases to level off at the Fed's annual inflation target of about 2%. Still, with wages following a similar trajectory, workers are left feeling the squeeze in their wallets, despite bigger pay days.

Follow the CPI

The most common measure of inflation is the Consumer Price Index, or CPI. The CPI is based on a monthly survey by the U.S. Bureau of Labor Statistics. It compares current and past prices on a "basket" of common expense categories, including housing, transportation, and clothing.

While inflation has been a constant fact of life in the U.S. economy, it can be particularly damaging to retirees, many of whom are living on fixed incomes. For many, Social Security is the only retirement income that increases through cost-of-living adjustments (COLAs) to reflect any increase in the cost of living as measured by the CPI.

It may be easy to overlook inflation when preparing for your financial future. After all, an inflation rate of just 2% to 3% -- which we have been experiencing for the past several decades -- may not seem worth noting, until you consider the impact it can have on your purchasing power over the long term.

Consider that at just a 3% inflation rate, a $100,000 nest egg today would be worth only $74,409 in today's dollars 10 years from now, $55,368 in 20 years, and $41,199 in 30 years.

As you can see from this example, the further away you are from retirement, the more potential inflation has to erode your future purchasing power, and the more important it is for you to choose investments that can potentially help you stay ahead of inflation.

Talk with your financial advisor to learn more about managing the impact of inflation on your investments.

[1]*The Wall Street Journal, "Don't Feel That Pay Raise? Blame Inflation," May 12, 2017.*

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