US yield curve doesn't yield the same insights

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- Yield curve changes are being driven by unconventional policies and technical factors, which make the moves harder to interpret.
- Curve flattening in 2016 has resulted from changes to money market rules at the short end and central bank purchases at the long end.
- Banks, municipalities and other borrowers are beginning to feel the pinch from rising Libor rates.
- Fundamentals remain the most important consideration for bond investors and the most valuable guide for pursuing medium- to longer-term goals.

The U.S. bond market yield curve long has been viewed as a leading indicator of economic activity. In the late stage of an expansion, a flattening of the curve might result from the U.S. Federal Reserve's action to raise its target fed funds rate in an attempt to control inflationary growth. At some point, the market would react to the tightening by a lowering of long-term rates in anticipation of a slowdown or a recession, further flattening or inverting the curve.

For better or worse, the old rules of thumb no longer apply today. This is hardly surprising, given the unique aspects of the 2008 global financial crisis, the scope of subsequent government and central bank actions, and the nature of the recovery. For example, we have had a flattening of the yield curve in 2016, but this comes as global central banks have continued monetary easing policies, including large-scale purchases of government bonds at the long end of the curve.

This buying has been an anchor on long-term U.S. Treasury rates, with the 10-year note falling 67 basis points (bps) this year through 30 September, even after the first move by the Fed to raise the fed funds rate in December 2015. If there is a market signal somewhere in the decline of long-term rates, it is hard to decipher given the scale of global central bank activity. Long-term rates, under government control, are now an unreliable indicator.

Following the Fed's facts

The view is hardly any clearer at the short end. One of the difficulties is that for all of its transparency, the Fed has pledged to be "data driven." That has left the market at the mercy of its expectations for key financial indicators like the jobs payroll number.

In Exhibit A, the probability percentages represent the market's expectation, at different times of the year, that the Fed will raise rates in December of this year, based on fed funds' futures pricing. For some reports, like February and March, it appears that the market correctly anticipated that the payroll numbers would be weaker or stronger than expected. It was less successful ahead of the April and June reports. On top of that, the 23 June Brexit shock also rattled the markets. The result has been extreme volatility in the market's expectation of when the Fed will continue to raise rates; the forecast has ranged from over 90% confidence at the start of the year to 10% post Brexit vote.

Exhibit A **The market's view on the likelihood of a rate hike this year has been highly volatile.**

Probability of rate hike on 14 December 2016 implied by fed funds futures

Sources: Eaton Vance, Bloomberg LLP, as of 30 September 2016. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for index definitions.

Money fund changes

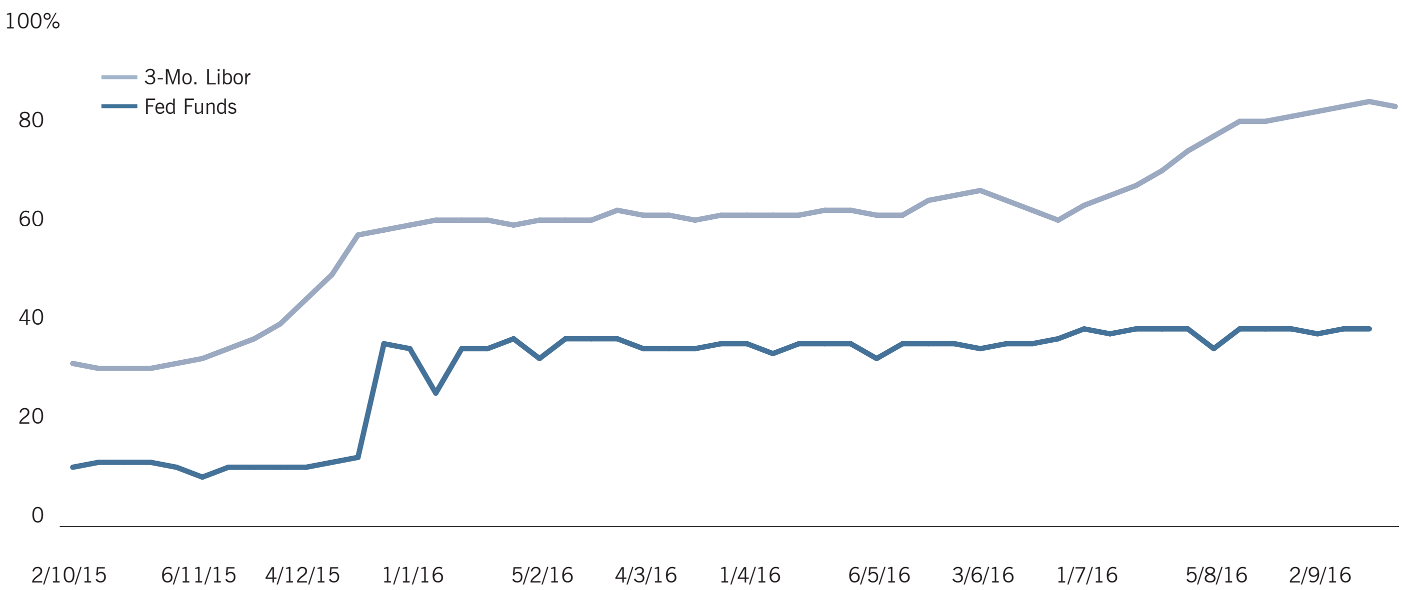
As noted above, this recovery also has been subject to technical variables not present in earlier cycles, in part due to regulations stemming from the Dodd-Frank reform act. For example, the SEC introduced new rules for money market funds, scheduled to take effect on 14 October 2016, which will allow funds to impose redemption fees and/or halt redemptions during times of stress; some funds will also be required to allow their NAVs to float, rather than be approximated as $1.

This has had a major impact on prime money market funds, which invest in bank commercial paper and other short-term debt. As the October deadline has approached, it has sparked an exodus by retail investors, while the funds have been shedding commercial paper and moving to liquidity in order to meet fund redemptions. The net result is that an important funding source for banks has become more expensive.

Upward pressure on Libor

So, while all eyes have been on the Fed and the fed funds rate, the flows out of prime funds (and likely into government funds) have reduced a funding source for banks and contributed to a rise in a key short-term benchmark – three-month Libor, which is based on the yields paid by banks for short-term credit. (While Libor is not controlled by the Fed, historically it has been highly correlated with the fed funds rate, and Libor typically rises when the fed funds rate does.) Exhibit B shows that while Libor and fed funds tracked fairly closely, they began to diverge in July – as of 30 September, Libor stood at 85 bps, more than twice the fed funds rate.

Exhibit B **While all eyes were on the fed funds rate, Libor has risen.**



Sources: Eaton Vance, Bloomberg LLP, as of 30 September, 2016. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for index definitions.

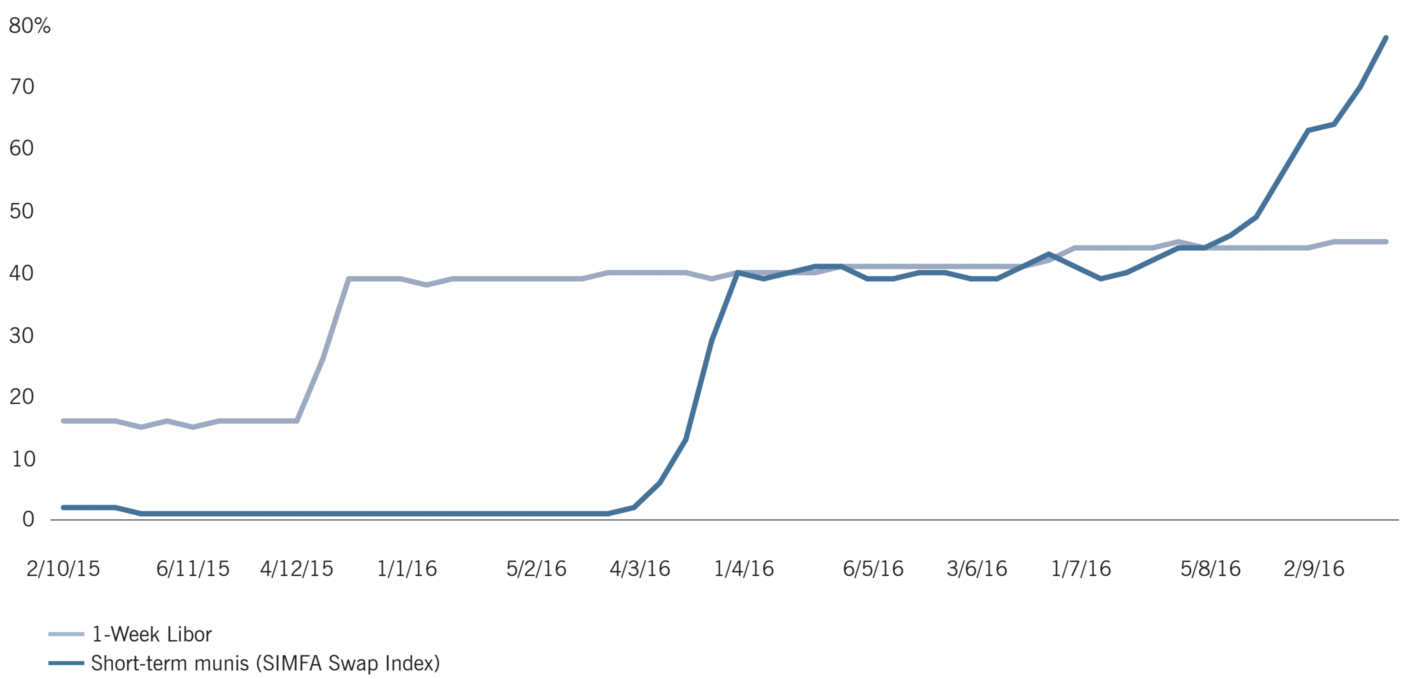
This is significant because many financial contracts such as banks loans, mortgages, student loans and credit cards are pegged to Libor. Its rise may not have the "headline" impact of a fed funds move, but there are many borrowers who will be feeling the ripple effect. As a practical matter, the Fed has had some of its planned tightening already done for it with Libor's increase, which represents a further rise at the short end of the yield curve.

Rising rates for municipalities

Municipalities are also feeling the pinch from the SEC's new money market rules. Many municipalities fund themselves through tax-exempt variable-rate demand obligations (VRDOs), with rates that change every week. (Technically, the investor has the right to "put" the VRDO back to a bank liquidity provider each week, and the bank adjusts the new rate in accordance with supply and demand.) The index that reflects this activity – the SIFMA Swap Index – is shown In Exhibit C, diverging from 1-week Libor in July. (Note that the 1-week Libor has a comparable maturity as the SIFMA Swap Index, and is not the same index as the 3-month Libor discussed above.)

Investors are fleeing tax-exempt money market funds for the same reasons as those withdrawing from taxable prime funds – fear of not being able to get out of a fund in a time of crisis. As a result, costs are rising both for short-term tax-exempt borrowers and short-term taxable borrowers.

Exhibit C **Short-term muni rates are rising, too.**



Sources: Eaton Vance, Bloomberg LLP, as of 30 September 2016. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for index definitions.

Hands on the dials

With so many "hands on the dials" (i.e., central banks, SEC regulators and even fines by government agencies – e.g., the U.S. Department of Justice's fine of a major European bank that elevated systemic risk), interpreting yield curve changes is more hazardous than usual. Our view is that U.S. growth prospects are reasonably solid, with key indicators like payrolls and inflation not far from Fed targets. Just over 50% of the market (Exhibit A) expects a 25 bps rate hike from the Fed in December, and we still believe that is the most likely outcome, so the fed funds rate may make up some ground on Libor. The downward pressure on the long end seems to be easing, as the Bank of Japan indicated it would be focusing its activity further down the curve. Similarly, the European Central Bank decided to stand pat at its most recent meeting. We saw some steepening at the long end at quarter's end, reflecting these signals.

The higher rate environment at the short end should open up opportunities to investors. VRDOs are currently attractive from a risk/return perspective and stand to yield more as rates rise and may be accessed by investing in tax-exempt vehicles outside of tax-exempt money market funds (e.g., short-term municipal bond mutual funds). Similarly, most floating-rate bank loans are pegged to Libor, so they also may deserve consideration.

A focus on fundamentals

Though technical factors and government policies are a part of any market environment, they appear to be the dominant drivers of the shape of today's U.S. yield curve. Ultimately, we believe market-based fundamentals will reassert themselves – continuing strength in the U.S. economy should result in higher interest rates at some point. Fixed-income investors who pay attention to the fundamentals as well as appreciate the asymmetric risk inherent in today's highest-quality bonds (most notably, U.S. Treasurys) should be well-rewarded over the medium to longer term.

Index definitions

The three-month London Interbank Offered Rate, or Libor, is based on the yields paid by banks for short-term credit and is a common short-term benchmark.

The one-week London Interbank Offered Rate, or Libor, is based on the yields paid by banks for short-term credit.

The Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index is a 7-day high-grade market index comprised of tax-exempt variable rate demand obligations (VRDOs), which are short-term notes issued by municipalities.

Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance.

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An imbalance in supply and demand in the income market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer's ability to make principal and interest payments. As interest rates rise, the value of certain income investments is likely to decline. An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. As interest rates rise, the value of certain income investments is likely to decline. Investments involving higher risk do not necessarily mean higher return potential. Diversification cannot ensure a profit or eliminate the risk of loss. Elements of this commentary include comparisons of different asset classes, each of which has distinct risk and return characteristics. Every investment carries risk, and principal values and performance will fluctuate with all asset classes shown, sometimes substantially. Asset classes shown are not insured by the FDIC and are not deposits or other obligations of, or guaranteed by, any depository institution. All asset classes shown are subject to risks, including possible loss of principal invested. The principal risks involved with investing in the asset classes shown are interest-rate risk, credit risk and liquidity risk, with each asset class shown offering a distinct combination of these risks. Generally, considered along a spectrum of risk and return potential, U.S. Treasury securities (which are guaranteed as to the payment of principal and interest by the U.S. government) offer lower credit risk, higher levels of liquidity, higher interest-rate risk and lower return potential, whereas asset classes such as high-yield corporate bonds and emerging-market bonds offer higher credit risk, lower levels of liquidity, lower interest-rate risk and higher return potential. Other asset classes shown, such as municipal and investment-grade bonds, carry different levels of each of these risk and return characteristics, and as a result generally fall varying degrees along the risk/return spectrum.

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