



US yield curve doesn't yield the same insights

Payson F. Swaffield, CFA
Chief Income Investment Officer
Eaton Vance Management

- 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

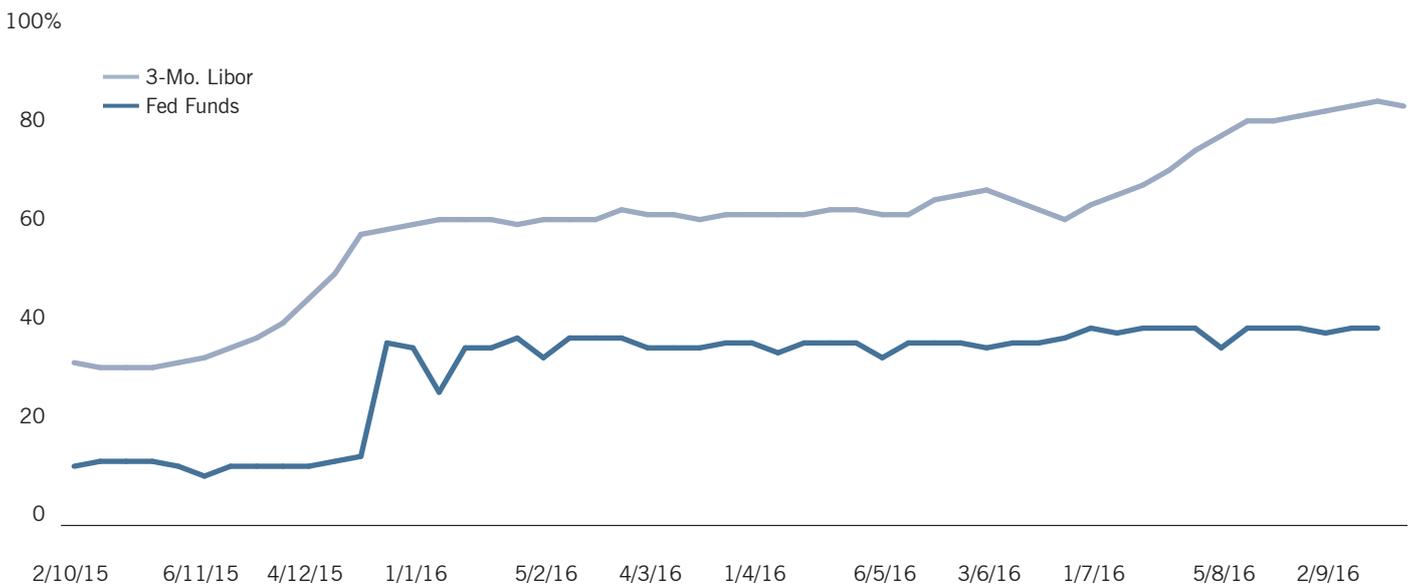
As noted above, this recovery also has been subject to technical variables not present in earlier cycles, in part due to regulations stemming from the Dodd-Frank reform act. For example, the SEC introduced new rules for money market funds, scheduled to take effect on 14 October 2016, which will allow 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.

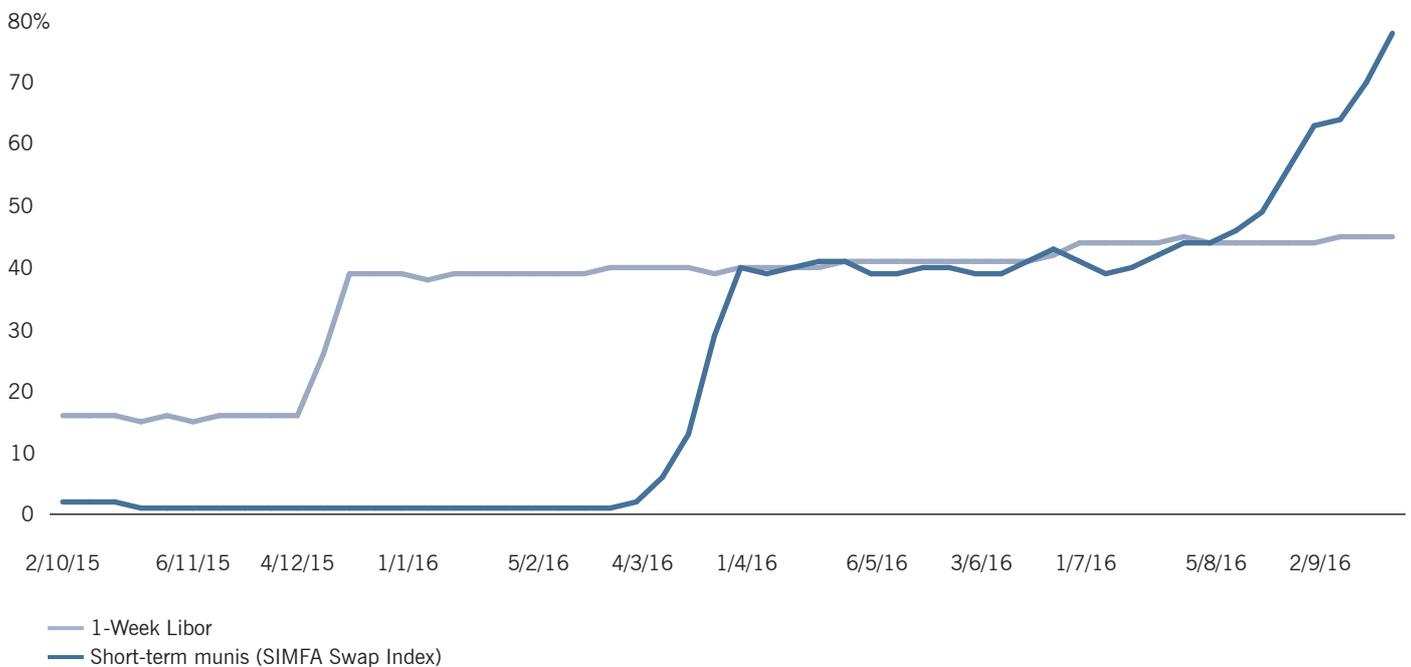
Rising rates for municipalities

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. Treasuries) 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.



About Risk

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.

Costs and expenses associated with investing in asset classes shown will vary, sometimes substantially, depending upon specific investment vehicles chosen. No investment in the asset classes shown is insured or guaranteed, unless explicitly stated for a specific investment vehicle. Interest income earned on asset classes shown is subject to ordinary federal, state and local income taxes, excepting U.S. Treasury securities (exempt from state and local income taxes) and municipal securities (exempt from federal income taxes, with certain securities exempt from federal, state and local income taxes). In addition, federal and/or state capital gains taxes may apply to investments that are sold at a profit. Eaton Vance does not provide tax or legal advice. Prospective investors should consult with a tax or legal advisor before making any investment decision.



About Eaton Vance

Eaton Vance is a leading global asset manager whose history dates to 1924. With offices in North America, Europe, Asia and Australia, Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company's long record of providing exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today's most discerning investors. For more information about Eaton Vance, visit eatonvance.com.

About EVM I

Eaton Vance Management (International) Limited (EVM I) is a subsidiary of Eaton Vance Management, a leading U.S. asset management organisation, and markets internationally the investment capabilities of Eaton Vance Management and its affiliates, including Parametric Portfolio Associates LLC. EVM I has been based in London since 2001.

This material does not constitute an offer or solicitation to invest in any Eaton Vance fund and/or products. Forecasts may not be attained. Past performance is no guarantee of future results. This material is communicated by Eaton Vance Management (International) Limited (EVM I), which is authorised and regulated in the United Kingdom by the Financial Conduct Authority and located at 125 Old Broad Street, London, EC2N 1AR, United Kingdom, Tel. +44 (0)203.207.1900.

EVM I is a wholly owned subsidiary of Eaton Vance Management (EVM). EVM is an investment advisor registered with the United States Securities and Exchange Commission (SEC) and is a wholly owned subsidiary of Eaton Vance Corp. (EVC). The nonvoting common stock of EVC, parent company of EVM, is publicly traded on the NYSE under the symbol "EV." For purposes of this material, "Eaton Vance" or the "Company" is defined as all three entities operating under the Eaton Vance brand.

EVM I markets the services of the following strategic affiliates: Parametric Portfolio Associates LLC (Parametric) is an investment advisor registered with the SEC and is a majority-owned subsidiary of EVC and Hexavest, which is an investment advisor based in Montreal, Canada, registered with the SEC in the United States and which has a strategic partnership with Eaton Vance, who owns 49% of the stock of Hexavest Inc.

In Singapore, EVM I has a wholly owned subsidiary, namely Eaton Vance Management International (Asia) Pte. Ltd. (EVM IA), 8 Marina View, Asia Square Tower 1, #07-05, Singapore 018960, which holds a Capital Markets License under the Securities and Futures Act of Singapore (CMS100185-1), is an exempt Financial Adviser pursuant to the Financial Adviser Act Section 23(1)(d) and is regulated by the Monetary Authority of Singapore. This document is to be distributed to Accredited Investors ONLY (as defined in the Securities and Futures Act, Chapter 289 of Singapore).

In Australia, EVM I is exempt from the requirement to hold an Australian financial services license under the Corporations Act in respect of the provision of financial services to wholesale clients as defined in the Corporations Act 2001 (Cth) and the Australian Securities and Investments Commission's Class Order 03/1099.

EVM I is registered as a Discretionary Investment Manager in South Korea pursuant to Article 18 of Financial Investment Services and Capital Markets Act of South Korea.

Eaton Vance Management (International) Limited utilises a third-party organisation in the Middle East, Wise Capital (Middle East) Limited (Wise Capital), to promote the investment capabilities of Eaton Vance to institutional investors. For these services, Wise Capital is paid a fee based upon the assets that Eaton Vance provides investment advice to following these introductions.

This document does not constitute an offer to sell or the solicitation of an offer to buy any Securities/Notes/Fund Units/Services referred to expressly or impliedly in this document in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC") to any person to whom it is unlawful to make the offer or solicitation in the PRC.

The document may not be provided, sold, distributed or delivered, or provided or sold or distributed or delivered to any person for forwarding or resale or redelivery, in any such case directly or indirectly, in the People's Republic of China (the PRC, excluding Hong Kong, Macau and Taiwan) in contravention of any applicable laws.

Eaton Vance Management (International) Limited is licensed by the United Kingdom Financial Conduct Authority to engage in the investment management business and hereby operates in Japan under Article 58-2, and Article 61, Paragraph 1 of the Financial Instruments and Exchange Act of Japan. Accordingly, services provided by Eaton Vance Management (International) Limited are available to Japanese investors only to the extent permitted under Article 58-2 and Article 61, Paragraph 1.

The views expressed in this material are those of the authors and are current only through the date stated at the top of this page. These views are subject to change at any time based upon market or other conditions, and Eaton Vance disclaims any responsibility to update such views. These views may not be relied upon as investment advice and, because investment decisions for Eaton Vance are based on many factors, may not be relied upon as an indication of trading intent on behalf of any Eaton Vance fund.

This material may contain statements that are not historical facts, referred to as forward-looking statements. A fund's future results may differ significantly from those stated in forward-looking statements, depending on factors such as changes in securities or financial markets or general economic conditions, the volume of sales and purchases of fund shares, the continuation of advisory, administrative and service contracts, and other risks. This material is for professional clients only.

©2016 Eaton Vance Management (International) Limited
 125 Old Broad Street, London, EC2N 1AR, United Kingdom
 Telephone: +44 (0)203.207.1900
 E-mail: internationalenquiries@eatonvance.com
 23447 10.13.16

