The StockCharts.com Market Message

Featuring our commentators, John Murphy and Arthur Hill

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COMPARISON OF BOND CATEGORIES SUPPORTS THE CASE FOR HIGHER BOND YIELDS -- HIGH YIELD BONDS ARE OUTPERFORMING INVESTMENT GRADE CORPORATES -- CORPORATE BONDS AND TIPS ARE OUTPERFORMING TREASURIES -- SHORTER-MATURITY BONDS ARE OUTPERFORMING LONGER MATURITIES -- CHART OF 20+ YEAR TREASURY BOND ISHARES LOOKS TOPPY

By John Murphy

HIGH YIELD BONDS ARE OUTPERFORMING INVESTMENT GRADE BONDS... One of the ways that we can tell which way interest rates are expected to trend is to compare the relative performance of various bond categories. Let's start with corporate bonds. Chart 1 is a **ratio** of the **iBoxx High Yield Corporate Bond iShares (HYG)** divided by the **iBoxx Investment Grade Corporate Bond iShares (LQD)** over the last year. The ratio rallied sharply after the November election as riskier high yield bonds were favored. Throughout most of this year, the falling ratio showed investors favoring investment grade bonds. After trading sideways since June, the ratio appears to be turning up (see circle). A move above its July peak would turn the scales in favor of high yield bonds once again. What is that telling us? High yield bonds are more closely tied to stocks than bonds. So they do better when stocks are rising and bond prices are falling (as they are now). As a result, high yield bonds usually do better when bond yields are rising. Investment grade bonds are more negatively impacted by rising rates. For those reasons, a rising **high yield/investment grade corporate ratio** usually favors higher bond yields. Chart 1 also shows that the high yield/investment grade bond ratio usually rises and falls with the **10-Year Treasury yield** (dotted line).

(click to view a live version of this chart)

Chart 1

INVESTMENT GRADE BONDS ARE OUTPERFORMING TREASURIES ... While investment grade corporate bonds are lagging behind high yields bonds, they're doing better than Treasuries. The solid line in Chart 2 is a **ratio** of the **iBoxx Investment Grade iShares (LQD)** divided by **20+Year Treasury Bond iShares (TLT)**. Chart 2 also shows that the ratio tracks the **10-Year Treasury yield** (dotted line) very closely. There's a reason for that. Long term Treasuries are much more sensitive to the direction of bond yields. So when bond yields are rising (and bond prices are falling), Treasuries will be much more negatively impacted than corporate bonds. As a result, the ratio rises. After declining for much of this year, investment grade bonds are outperforming Treasuries during September (a rising ratio). That's also consistent with higher bond yields. [**Footnote:** The TLT has lost -2.6% during September. The LQD has also lost ground, but by a smaller amount (-.30%). The HYG is the only bond category in positive territory for the month (0.45%)].

(click to view a live version of this chart)

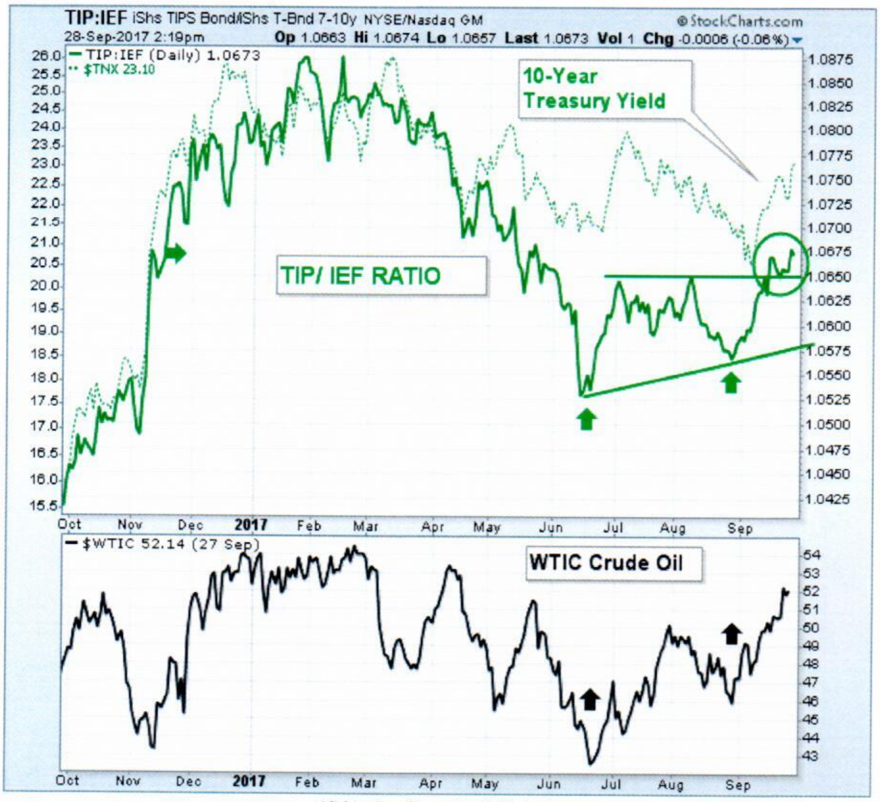
Chart 2

SHORTER MATURITY BOND ETF IS STARTING TO OUTPERFORM... When bond yields are rising (or are expected to rise), longer maturity bonds will lost more ground than shorter maturities. The longer the maturity of a bond, the more sensitive it is to rising yields. Chart 3 is a **ratio** of the **7-10 Year Treasury Bond iShares (IEF)** divided by the **20+ Year Treasury Bond iShares (TLT)**. After rising sharply last November (along with the **10-Year Treasury Yield**), the ratio fell throughout most of this year. The ratio, however, is starting to turn up. That would also be consistent with expectations for higher bond yields. The reason is simple. Both bond ETFs will fall when bond yields are rising. But the shorter maturity IEF will lose less ground that the longer maturity TLT. During September, the IEF has lost -1.3%. The TLT, however, has dropped twice as much (-2.6%). If the ratio in Chart 3 keeps rising, that would another vote for higher bond yields.

(click to view a live version of this chart)

Chart 3

TIP ARE OUTPERFORMING TREASURIES... Here's one last ratio that appears to show that fixed income traders are starting to price in higher bond yields and higher inflation. The solid line in Chart 4 is a **ratio** of **TIPS Bond iShares (TIP)** divided by the **7-10 Year Treasury Bond iShares (IEF)**. The dotted line is the **10-Year Treasury yield**. There again, the ratio rose last November with yields, fell with yields for most of the year, and has now risen to the highest level in four months (along with yields). What does that mean? TIPS stand for **Treasury Inflation Protected Securities**. TIPS are bought for protection against rising inflation. The fact that they're starting to do better than Treasuries suggests that investors are starting to price in higher inflation. That's also consistent with higher bond yields. And what could be booting inflation expectations? The black line below Chart 4 shows the price of **WTIC crude oil** rising to the highest level in five months. If you compare the up arrows on the oil chart to the arrows on the TIP/ IEF ratio in the body of the chart, you'll see a positive correlation between the two lines.



(click to view a live version of this chart)

Chart 4

TLT CHART LOOKS TOPPY... If and when bond yields really start rising, longer maturity Treasury bonds will be hit the hardest. That being the case, the best place to look for directional clues is the longest maturity bond ETF that we have. And that's the **20+ Year Treasury Bond iShares (TLT)** shown in Chart 2. And the chart presents an ominous picture. The weekly bars suggest a possible "head and shoulders" top forming since the start of

2015. Notice that the two potential "shoulders" peaked around the same level (red arrows). The potential "head" is the middle peak formed in during 2016. A "neckline" is drawn under its 2015/ 2017 lows (red line). The TLT may be headed for a test of that key support line. Any serious violation of the red line would signal a major bond top. [**Footnote:** Since 2009, longer maturity bonds were the strongest part of the yield curve. That's because bond yields were falling. Since bond yields bottomed in mid-2016, however, longer dated bonds have been the weakest Treasury performers. They're like the "canary in the coal mine". If Treasury ETFs are finally peaking, the TLT will be the first one to fall. The others will follow.

(click to view a live version of this chart)

Chart 5

KUDOS TO KUDLOW... I'm referring of course to Larry Kudlow who appears regularly on CNBC. I watched a panel discussion on Tuesday which talked about Janet Yellen's description of persistently low inflation as a "mystery". Kudlow suggested that the reason it was a mystery to the Fed is because of its reliance on economic models (like the Phillips Curve) that have never had much success predicting inflation. Kudlow longs for the old days when the Fed followed forward-looking markets like the dollar and commodity prices to gauge the direction of inflation. I'm in complete agreement. I would also suggest looking at the relationships between various bond categories contained in this message for directional clues. Financial markets are forward looking, while economic indicators look backwards. Relying on economic indicators, while ignoring the message of financial markets, is like driving a car by only looking out the rear view mirror. Looking ahead instead of backwards also makes the route more predictable and a lot less mysterious.

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