

Bond Market Perspectives

January 7, 2014

Ring in the New Year

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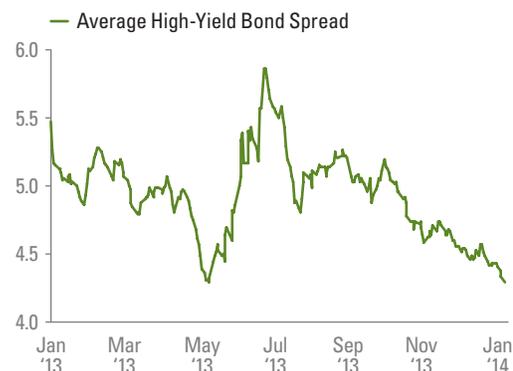
Highlights

As the year begins, bond prices are broadly higher and seemingly contradict bond market participants' tapering concerns.

High-yield bonds and bank loans should benefit from an improving economy and low default environment in 2014.

The key underlying theme of bond yields tracking the health of the economy has not changed and will likely continue for 2014.

1 The Average Yield Advantage of High-Yield Bonds Dropped to a Post-Recession Low



Source: Barclays, LPL Financial 01/06/14

Past performance is no guarantee of future results.

High-Yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

After a difficult 2013 for most sectors, the bond market is ringing in the New Year with enthusiasm. Bond prices are broadly higher with the Barclays Aggregate Bond Index up by 0.23% through the first three trading days of 2014. Although returns remain modest on an absolute level, the positive reaction seems to contradict fears of how a reduction in Federal Reserve (Fed) bond purchases might adversely impact the bond market. In fact, sectors more sensitive to Fed bond purchases, such as mortgage-backed securities (MBS) and Treasury Inflation-Protected Securities (TIPS) have exhibited better price performance relative to Treasuries since the conclusion of the December 18, 2013 Fed meeting through Monday, January 6, 2014.

More economically sensitive, lower-rated bonds are ringing in the New Year with gusto, continuing a rally that began following the December Fed meeting. Prices of high-yield bonds, bank loans, and preferred securities started the first few days of 2014 on a particularly strong note, showing little concern over the potential impact of a reduction in Fed bond purchases and focusing instead on the improving economic data. The average yield spread of high-yield bonds contracted to its narrowest level since May 2013, which in turn matches a post-recession low [Figure 1].

The behavior of high-yield bonds and bank loans is less surprising and continues a trend evident for most of 2013. These sectors have historically weathered rising interest rates better than most fixed income sectors and benefited from an improving economy and low default environment—two trends that we expect to continue in 2014.

The lack of interest rate sensitivity should help high-yield bonds and bank loans weather gradually rising interest rates in 2014. Fear over a reduction in Fed bond purchases and a less bond-friendly Fed was a primary driver of negative returns for most bond sectors in 2013 [Figure 2]. High-quality bonds suffered their worst year since 1994, and 2013 was one of only three years, in nearly 40 years of data, in which the broad Barclays Aggregate Bond Index produced a loss.

We continue to favor high-yield bonds for 2014, but the narrower yield spread indicates that returns for high-yield bond investors in 2014 may be lower than what investors experienced in 2013. The high-yield bond

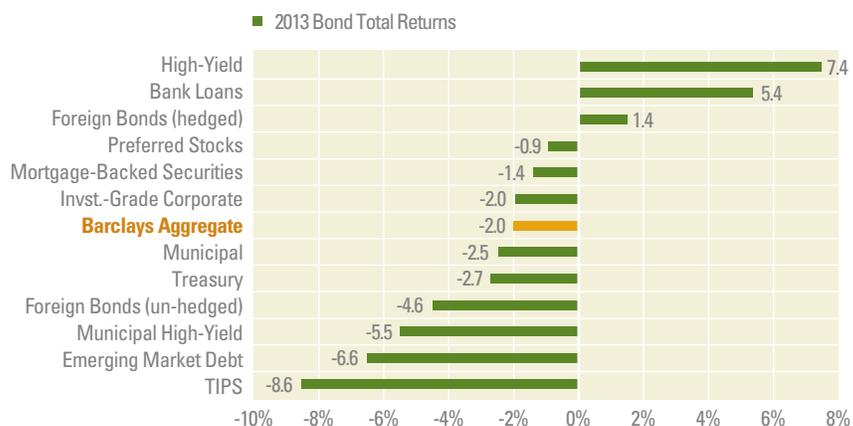


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High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Bank loans are loans issued by below investment-grade companies for short-term funding purposes with higher yield than short-term debt and involve risk.

2 2013 Performance Scorecard



Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial 12/31/13

Ranked by 2013 total returns

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

All indexes are unmanaged. Past performance is no guarantee of future results. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

Asset Class Indexes: High-Yield—Barclays US High Yield Corporate Index; Bank Loans—Barclays US High-Yield Loan Index; Foreign Bonds (hedged)—Citigroup Non-US World Govt Bond Index Hedged for Currency; Preferred Stocks—Merrill Lynch Preferred Stock Hybrid Index; Mortgage-Backed Securities—Barclays US MBS Index; Invst-Grade Corporate—Barclays US Corporate Bond Index; Municipal—Barclays Municipal Bond Index; Treasury—Barclays US Treasury Index; Foreign Bonds (un-hedged)—Citigroup Non-US World Govt Bond Index (un-hedged); Municipal High-Yield—Barclays Municipal High-Yield Index; Emerging Market Debt—JP Morgan Emerging Markets Global Index; TIPS—Barclays Treasury Inflation Protected Securities Index.

sector was the only one to witness a decline in average yields in 2013, and the lower yields will likely translate to lower returns for the new year. Conversely, higher yields on high-quality bonds should help cushion the impact of rising rates in 2014 [Figure 3], but yields remain low by historical comparison and we expect 2014 to be a challenging year with high-quality bond returns likely to be flat.

3 Higher Yields Among High-Quality Bonds May Better Offset Rising Rates in 2014

Benchmark	Yield (%)		Change
	12/31/12	12/31/13	
30-Year "Current Coupon" Ginnie Mae	2.1%	3.4%	1.4%
10-Year Treasury	1.8%	3.0%	1.3%
10-Year AAA-Rated Municipal	1.8%	2.8%	1.0%
Moody's Corporate Bond Average	4.1%	4.9%	0.9%
Barclays High-Yield Index	6.1%	5.6%	-0.5%

Source: Barclays, Bloomberg, Moody's, LPL Financial 12/31/13

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Credit Quality is one of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio's credit worthiness, or risk of default.

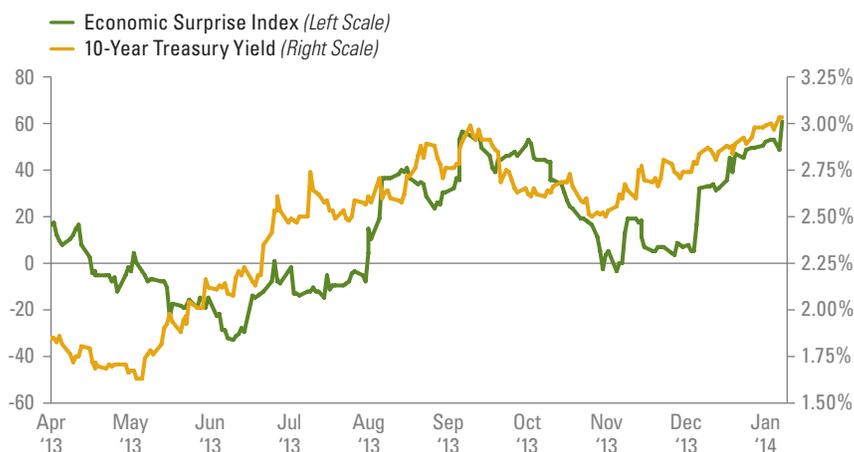


The bond market is ringing in the New Year with enthusiasm, but early gains occurred amid thinly traded markets, and the bond market will get a better test this week as market participants return. The U.S. Treasury will auction new 3-, 10-, and 30-year bonds, and the supply may pose a good test of investor demand. The proximity of key yield barriers—3.0% on the 10-year and 4.0% on the 30-year Treasury—has brought out buyers so far, but that may be challenged this week by new supply via the auctions.

A defensive positioning with lower-than-benchmark duration and an emphasis on lower rated bonds is still warranted despite early year enthusiasm in the bond market.

Looking out further, investors should note that the key underlying theme of bond yields tracking the health of the economy has not changed and is likely to continue for 2014 [Figure 4]. The Fed acknowledged the improvement in the economy as a rationale to begin removing bond purchases. The bond market further acknowledged this sentiment via the highest inflation expectations in eight months, as measured by 10-year TIPS, and a modest creep forward in expectations for the Fed’s first rate hike to September 2015, up from November 2015. A defensive positioning with lower-than-benchmark duration and an emphasis on lower-rated bonds is still warranted despite early-year enthusiasm in the bond market. ■

4 Better Economic Data Will Likely Continue to Drive Yields Higher in 2014



Source: Citigroup, Bloomberg, LPL Financial 01/06/14

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The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs Bloomberg survey median). A positive reading of the Economic Surprise Index suggests that economic releases have on balance beating consensus. The indices are calculated daily in a rolling three-month window. The weights of economic indicators are derived from relative high-frequency spot FX impacts of 1 standard deviation data surprises.



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 referenced is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly.

This information is not intended to be a substitute for specific individualized tax advice. We suggest that you discuss your specific tax issues with a qualified tax advisor.

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.

Mortgage-backed securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Preferred stock investing involves risk, which may include loss of principal.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI)—while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of is that the CPI might not accurately match the general inflation rate; so the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Treasuries are marketable, fixed-interest U.S. government debt securities. Treasury bonds make interest payments semi-annually, and the income that holders receive is only taxed at the federal level.

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.

Government bonds and Treasury bills are guaranteed by the US 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.

INDEX DESCRIPTIONS

The Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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