Bond Market Perspectives

October 1, 2013

Many Happy Returns

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Highlights

September bond market performance saw gains across all major sectors due to the Fed's no tapering news, higher yields, and better valuations.

Despite a strong September, we remain cautiously optimistic that bonds can deliver positive (albeit more modest) returns.

Bond prices and yields will likely be rangebound through year end.

The phrase "many happy returns" is often used for a birthday greeting and meant to augur a long, successful life. More broadly, the term can be used as a greeting to offer hope that a festive event would repeat many more times in the future. The current bond market environment can hardly be described as festive, but the month of September has bond investors exclaiming "many happy returns" following one of the better monthly performances of the past two years.

Return of the Rally

After a difficult four months, high-quality bonds returned to the green in September with a 1.0% total return, according to the Barclays Capital U.S. Aggregate Bond Index. Monthly gains of 1.0% or more are rare and have occurred on only four occasions over the past two years. Absent modest weakness among preferred securities, all major sectors of the bond market witnessed gains in September, thanks in large part to the Federal Reserve's (Fed) decision to not taper bond purchases, but also due to the higher yields and better valuations that put the bond market on better footing heading into the Fed meeting. The 10-year Treasury yield peaked at 3.0% on September 5, 2013, before finishing the month notably lower at 2.6%.

> We still expect that sectors adversely affected during the sell-off, such as municipal bonds and EMD, may continue to benefit over the intermediate to longer term.

Performance was led either by sectors more sensitive to Fed bond purchases, such as mortgage-backed securities (MBS) and/or those that were more adversely impacted during the sell-off, such as Treasury Inflation-Protected Securities (TIPS), municipal bonds, and emerging market debt (EMD) [Figure 1]. As we mentioned in last week's commentary, all three areas may continue to be beneficiaries, although EMD pulled back slightly last week due to risk aversion.

Return of Risk Aversion

Investor concerns over the looming government shutdown and, more importantly, the approaching debt ceiling limit, gave high-quality bonds an additional lift last week (September 23–27, 2013) as risk aversion increased. More economically sensitive segments of the bond market, however, such as high-yield bonds, investment-grade corporate bonds, and EMD witnessed modest pullbacks last week despite a good month of September overall. In our view, a government shutdown is unlikely to have a meaningfully adverse impact on the economy unless it becomes a

1 Depressed Sectors Bounced Back in September

2013 Total Returns

Asset Class	Sep 2013	YTD
Municipal High-Yield	3.3	-5.1
Emerging Market Debt	2.7	-7.4
Foreign Bonds (un-hedged)	2.5	1.0
Municipal	2.2	-2.9
TIPS	1.5	-6.7
Mortgage-Backed Securities	1.4	-1.0
High-Yield	1.0	3.7
Barclays Aggregate	**1.0**	**-1.9**
Investment-Grade Corporate	0.8	-2.9
Foreign Bonds (hedged)	0.7	1.0
Treasury	0.7	-2.0
Bank Loans	0.2	3.6
Preferred Stocks	-0.3	-2.2

Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial 09/30/13

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

protracted affair lasting several weeks. A longer-term negative impact could arise should consumer confidence suffer.

Aside from an upcoming debt limit debate and uncertain impacts from a government shutdown, third quarter 2013 economic growth forecasts have been revised downward in recent weeks, raising concerns over the pace of economic growth. Gross domestic product (GDP) is expected to grow 2.0% during the third quarter of 2013 versus a prior expectation of 2.3%, according to a Bloomberg survey.

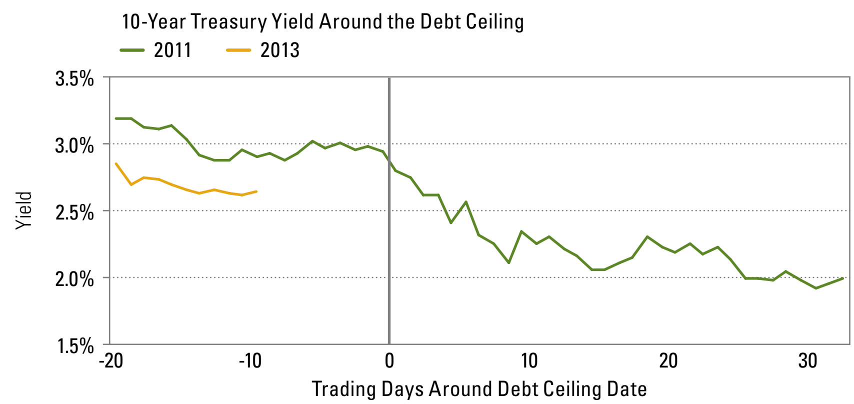
Not So Happy Returns

Government Shutdown and the Debt Ceiling

The start of a partial government shutdown on October 1, 2013 may benefit high-quality bonds as investors eye the possible economic impact. In our view, the impact of a government shutdown is likely to be very limited unless the shutdown were to last several weeks rather than just a few days. So far, reaction has been limited as the bond market continues to adjust to the Fed's decision to not taper bond purchases. Nonetheless, the uncertainty around a potential government shutdown, and the possibility of a continuing resolution extending funding only to mid-November or mid-December, may help keep bonds supported.

The Treasury Department has cited October 17, 2013 as a hard deadline on the debt ceiling before Washington shenanigans may have a broader impact on the economy. Starting on October 17, 2013, the Treasury will have to begin prioritizing payments. The Treasury continues to receive income throughout the month, but after October 17, not all obligations can be met, leading to a potentially greater economic impact as more individuals and government vendors do not receive payment. The end of October brings several large payments, which the Treasury will not be able to pay unless the debt limit is increased. The 2011 debt limit debate led to a sharp rise in bond prices and drop in yields [Figure 2]. A big difference between the

2 High-Quality Bond Prices May Be Supported by Events in Washington



Source: Bloomberg, Treasury Dept, LPL Financial 10/1/2013. In 2011, the Treasury stated that 8/2/2011 was the ultimate hard deadline on the debt limit; for 2013, the Treasury has stated that 10/17/2013 is the corresponding hard deadline.

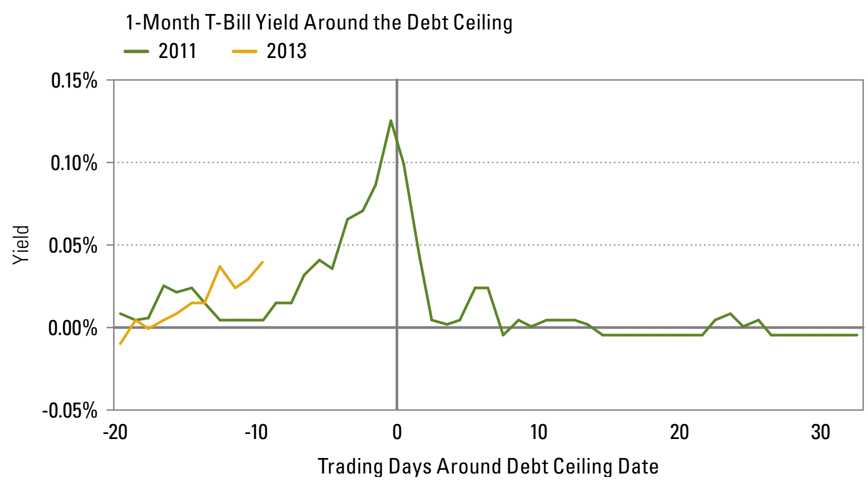
Past performance is no guarantee of future results.

A big difference between the current debt limit environment and that of 2011 is the added European debt problem and corresponding economic concerns.

current debt limit environment and that of 2011 is the added European debt problem and corresponding economic concerns. With both the U.S. and European economies on better footing now and a host of central bank liquidity backstops in place, the prospects of a similar rise in high-quality bond prices and drop in yields is limited.

While we view the risk of default to be extremely low, short-term T-bills are likely to reflect the brunt of any debt limit concerns [Figure 3], just as they did two years ago. Investor concerns about the Treasury's ability to redeem and roll over these short-maturity obligations led to higher yields, but the reaction so far has been muted and low absolute yield levels suggest extremely limited market concern.

3 T-Bill Yields Have Increased, but the Low Absolute Level of Yields Reflects Extremely Limited Prospects of a Default



Source: Bloomberg, Treasury Dept, LPL Financial 10/01/13

In 2011, the Treasury stated 08/02/11 as the ultimate hard deadline on the debt limit, and for 2013, the Treasury has stated 10/17/13 as the run-out-of-cash date.

Past performance is no guarantee of future results.

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.

Fed fund futures indicate bond market expectations of Fed rate hikes are roughly in line with guidance provided by the Fed, versus the aggressive rate hike path priced into markets early in September, indicating the bond market has adjusted and further gains may be limited.

We expected a more muted bond reaction to the debt limit now compared to 2011, due to a better global economic backdrop as well as more supportive central banks. Fed fund futures indicate bond market expectations of Fed rate hikes are roughly in line with guidance provided by the Fed, versus the aggressive rate hike path priced into markets early in September, indicating the bond market has adjusted and further gains may be limited. Bond prices and yields are likely rangebound in a wait-and-see approach until more economic data reveal the pace of economic growth and labor market improvement and its potential influence on whether the Fed reduces bond purchases in December. Although September was a month of happy returns for the bond market, we do not expect similar jubilant months for the remainder of the year. However, we remain cautiously optimistic that bonds can deliver positive albeit more modest returns going forward. ■

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 indices are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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.

Corporate bonds are considered higher risk than government bonds but normally offer a higher yield and are subject to market, interest rate and credit risk as well as additional risks based on the quality of issuer coupon rate, price, yield, maturity and redemption features.

The Fed funds futures curve graphically represents the anticipated Fed funds rate at future points in time.

The Fed funds rate is the interest rate on loans by the Fed to banks to meet reserve requirements.

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

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.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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

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.

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 - while providing a real rate of return guaranteed by the U.S. Government.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

INDEX DESCRIPTIONS

The Barclays Capital Aggregate Bond Index is an unmanaged market capitalization-weighted index of most intermediate-term U.S. traded investment-grade, fixed rate, non-convertible and taxable bond market securities including government agency, corporate, mortgage-backed, and some foreign bonds.

The Barclays Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment-grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

The Barclays Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (Strips), or Treasury Inflation Protected Securities (TIPS).

The Barclays Corporate Index is an unmanaged index of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. The index includes both corporate and non-corporate sectors.

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-rate, taxable corporate bond market. Securities are classified as high-yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below. The index excludes emerging markets debt. The index was created in 1986, with index history backfilled to January 1, 1983. The U.S. Corporate High Yield Index is part of the U.S. Universal and Global High Yield Indices.

J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for U.S. dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. Currently, the EMBI Global covers 188 instruments across 33 countries.

The Barclays Municipal Bond Index is a market capitalization-weighted index of investment-grade municipal bonds with maturities of at least one year. All indices are unmanaged and include reinvested dividends. One cannot invest directly in an index. Past performance is no guarantee of future results.

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

The Citigroup Non-U.S World Government Bond Index (Un-hedged) is calculated on a market-weighted basis and includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of U.S. $25 million. The Index excludes floating or variable rate bonds, securities aimed principally at non-institutional investors and private placement-type securities.

The Citigroup World Government Bond Index is a market-capitalization-weighted index consisting of the government bond markets. Country eligibility is determined based on market capitalization and investability criteria. All issues have a remaining maturity of at least one year.

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflationprotected securities issued by the U.S. Treasury. The U.S. TIPS Index is a subset of the Global Inflation-Linked Index, with a 36.0% market value weight in the index (as of December 2007), but is not eligible for other nominal treasury or aggregate indices. In order to prevent the erosion of purchasing power, TIPS are indexed to the non-seasonally adjusted Consumer Price Index for All Urban Consumers, or the CPI-U (CPI).

The Barclays Mortgage-Backed Securities Index includes 15- and 30-year fixed-rate securities backed by mortgage pools of the Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (FHLMC), and Federal National Mortgage Association (FNMA).

The Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The Index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.