Bond Market Perspectives

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Tug-of-War

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Highlights

The tug-of-war between stronger economic data and expectations for a delay to Fed tapering will likely lead to range-bound trading through the end of 2013.

On a longer-term basis, we believe the tug-of-war will ultimately be won by economic data, and upward pressure on yields will resume.

The presidents of regional Federal Reserve Banks are commonly classified as hawks or doves. Hawks generally favor tighter monetary policy, with less monetary support from the Federal Reserve. Doves are the opposite, generally favoring easing of monetary policy.

The tug-of-war between better economic data and a delayed start to Federal Reserve (Fed) tapering continues in the bond market. Both factors can be interrelated, but over the past week, bond investors appear to be siding with the notion that the Fed, under Fed Chairwoman nominee Janet Yellen, may need more proof before reducing bond purchases, despite the recent improvement in economic data and a strong corporate earnings season.

The stalemate has led to a range-bound bond market, which we believe will likely continue through year-end. Bond yields can remain in broad ranges for long periods of time. That was the case from late 2012 until early May 2013 before yields broke higher [Figure 1]. After dropping to a 2.50% yield, the 10-year Treasury rose to 2.78% following strong economic reports in early November that helped boost expectations that the Fed may begin to taper bond purchases as early as next month. However, dovish comments from Yellen's confirmation hearing helped the 10-year Treasury yield fall in recent days, closing back down at 2.67% on Monday, November 18, 2013. Many of Yellen's comments were unsurprising but helped calm bond investors' nerves in the absence of noteworthy economic data, leading to lower yields.

1 Yields May Remain Range-Bound Through Year-End

Source: LPL Financial Research, Bloomberg 11/18/13

Past performance is no guarantee of future results.

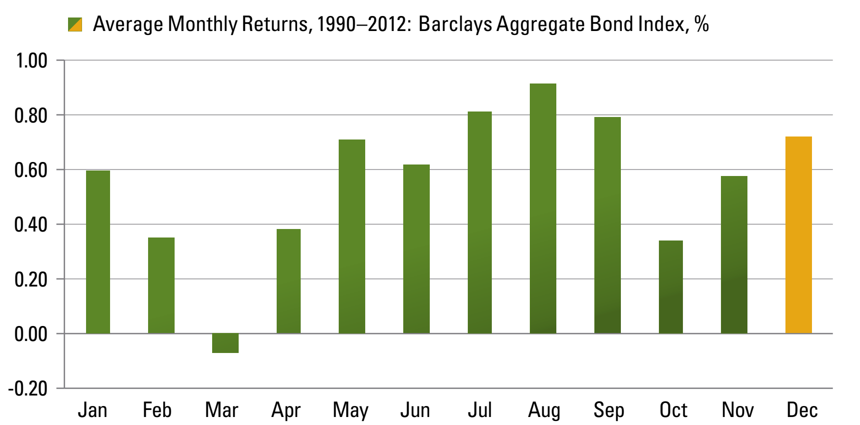
In our soon-to-be-released *Outlook 2014*, we make the case that the tug-of-war will ultimately be won by economic data, and upward pressure on yields will resume. But through the remainder of 2013, we believe 2.5% to 3.0% on the 10-year Treasury, marking the recent high and low in yield, may define the trading range. During a range-bound environment, price swings up or down usually offset each other, leaving interest income to drive returns. Low yields imply these returns will be modest, but likely positive, as investors "clip coupons"—a reference to days gone by when investors would detach coupons from paper bond certificates to redeem interest payments.

Year-End Dynamics

As the holidays approach and trading volume begins to diminish, bond dealers begin to retrench, causing markets to become less liquid. This environment generally leads to conservatism as investors avoid risks and seek more liquid, easily tradable bonds. High-quality bonds, especially Treasuries, are more liquid and therefore may benefit as investors seek a high-quality alternative through year-end.

This phenomenon partly explains what has historically been a good seasonal trend for high-quality bonds. December is among the better months for high-quality bonds based on average monthly returns going back to 1990 [Figure 2].

2 Historically, December Has Been a Good Month for Bonds



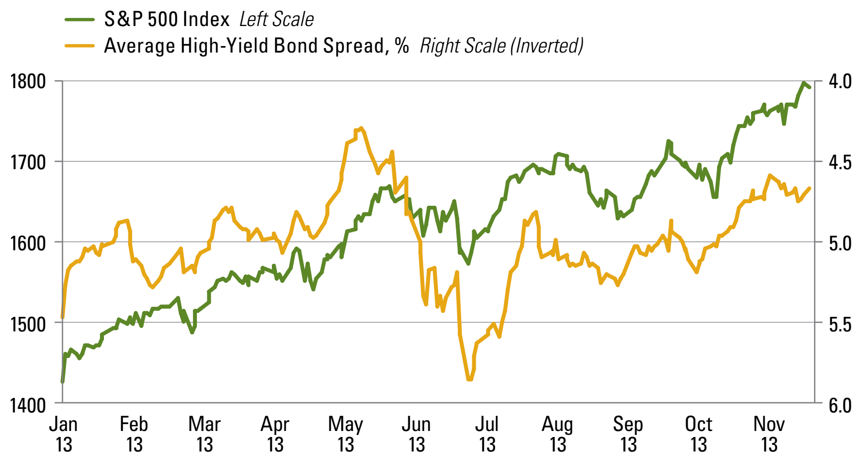
Source: LPL Financial Research, Barclays Aggregate Bond Index data 11/18/13

Past performance is no guarantee of future results.

The Barclays Aggregate Bond Index is an unmanaged index, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

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.

3 High-Yield Bond Valuations Have Failed to Match Higher Stock Prices Recently



Source: LPL Financial Research, Bloomberg, Barclays Index data 11/18/13

Past performance is no guarantee of future results.

The S&P 500 and Barclays Aggregate Bond Index are unmanaged indexes, which cannot be invested into directly. The returns do not reflect fees, sales charges or expenses. The results don't reflect any particular investment.

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

Sector Rotation

In a tough year for bonds, high-yield bonds have been a bright spot, but as we commented last week, higher valuations are motivating some investors to sell and rotate into higher-quality bonds. High-yield bond valuations, as measured by yield spreads, have failed to contract further, despite new highs in the equity market [Figure 3]. Normally, declining yield spreads and higher stock prices go hand in hand. With high-quality bond yields still close to the highs of the year, timing may have been compelling for a switch.

Other high-yield investors may have looked to invest in emerging market debt (EMD). While high-yield spreads contracted through early November 2013, EMD spreads widened over renewed growth fears to levels not seen since early September. The disparity likely played a role in income-seeking investors rotating out of high-yield bonds and into EMD due to better relative valuations.

Emerging market debt (EMD) is a term used to describe bonds issued by less developed countries. This type of debt is primarily issued by sovereign (government) issuers, and may be denominated in local currencies, or more heavily used currencies such as the Dollar or Euro.

The bond-market-friendly tone of Yellen's comments last week has helped arrest the rise in yields for now. Her remarks that the economic recovery has a long way to go and that she sees no distortion in asset prices boosted market expectations that Fed tapering may be delayed until early next year. Market participants will have to wait until the mid-December Fed meeting for clarity, if not longer, and a favorable seasonal trend may also support high-quality bonds. Yields are likely to be range-bound through the end of 2013, providing a coupon-clipping environment until a continued improvement in economic data could influence yields modestly higher in 2014. ■

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.

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.

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

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.

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 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.

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

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