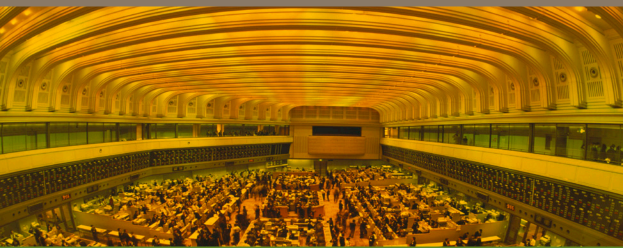
LPL FINANCIAL RESEARCH

Bond Market Perspectives



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Back to the Highs

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Highlights

A stronger-than-expected employment report, continued stock market strength, and reduced fiscal uncertainty pushed bond yields to their highs of the year.

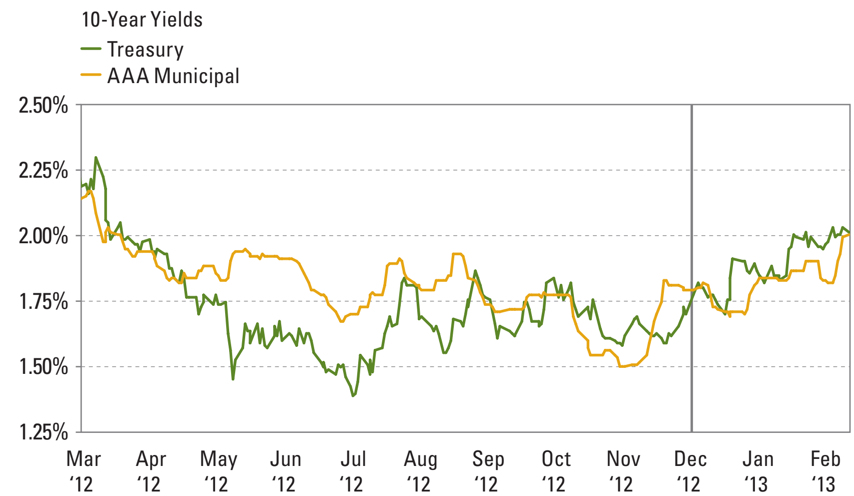
Federal Reserve (Fed) bond purchases accentuate a favorable supply-demand dynamic for the broad bond market.

We remain focused on corporate bond sectors, which have been the biggest beneficiaries of Fed policy.

For the purposes of this publication, 'high-quality' as it refers to bonds denotes a Moody's rating of Baa3 or higher and S&P rating of BBB- or higher and is broadly represented by the Barclays Aggregate Bond Index.

Bond yields are back to the highs of the year after gains from the prior week were more than erased. A stronger-than-expected employment report, continued stock market strength, and reduced fiscal uncertainty pushed the 10-year Treasury yield back to 2.06%. The municipal bond market, struggling with its own unique circumstances (see *Bond Market Perspectives: Waiting for the Spring*), was also impacted by taxable bond weakness. Taxable and tax-free yields are at their highs of the year [Figure 1].

1 Bond Yields Are at the Highs of the Year



Source: Bloomberg, MMA, LPL Financial 03/11/13

Fiscal policy uncertainty began to lessen last week, eroding a pillar of support for high-quality bonds. Congress is likely to approve a budget soon that will avoid a potentially damaging government shutdown at the end of March and fund the government through September. Last week, we commented on fiscal uncertainty providing support to high-quality bond prices, but with this risk lifting, a key bond support may be weakening.

Fed bond buying continues having a strong impact in the bond markets and accommodative policy is still in place.

Remaining Support

Still, high-quality bonds may garner support from the impact of sequestration, automatic spending cuts that were triggered at the start of March, and

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continued Federal Reserve (Fed) bond purchases. Spending cuts may translate into additional job losses and may keep economic growth slow. Sluggish growth is likely to keep inflation in check and help support bond prices. This helps explain why the bond market's reaction to last Friday's jobs report was limited to a 0.04% increase in the 10-year Treasury yield. Investors remain cautious and await further proof of an acceleration in jobs.

The latest quarterly flow of funds data from the Fed revealed just how impactful Fed bond buying has been in supporting the bond market. The total domestic bond market, taxable and tax-free, grew by $1.2 trillion in 2012, or 3% [Figure 2]. However, with the Fed on pace to purchase just over $1.4 trillion worth of bonds in 2013, bond market growth is on track to be slightly negative after taking into account Fed purchases. Note, this example assumes the Fed will keep purchase amounts unchanged through all of 2013. We believe this has a good chance of occurring based upon the dovish view of Fed Chairman Ben Bernanke and his companions at the Fed, who seem intent to keep monetary stimulus in place.

The Fed is not the only source of demand of course; reinvestment is another significant source of demand. As bonds mature and interest income is paid, investors reinvest in the bond market if they wish to maintain exposure.

Supply-demand factors are not the only driver of bond yields, but this dynamic should help limit any rise in bond yields.

2 Bond Market Growth Is Negative After Taking Into Account Fed Purchases

Outstanding U.S. Bond Market ($ Billions)

	4Q11	4Q12	$ Change	% Change
Treasury	10,428	11,569	1,141	11%
Mortgage-Related	8,339	8,168	-171	-2%
Corporate	8,325	9,088	763	9%
Federal Agencies	2,327	2,084	-243	-10%
Municipal Bonds	3,719	3,714	-5	0%
Money Market Instruments	2,572	2,461	-111	-4%
Asset-Backed	1,831	1,689	-142	-8%
Totals	37,542	38,773	1,231	**3%**

Less Current Pace of Fed Purchases ($ Billions)	Jan–Feb 2013	Annualized Pace	% Change
Treasury & Mortgage-Backed Securities	238	1,438	NA
Total Bond Market (from above) less current annualized pace of Fed Purchases:		37,335	-1%

Source: Federal Reserve, SIFMA, LPL Financial 3/11/13

Average Treasury and mortgage-backed security (MBS) yields are higher now compared to just before the start of the Fed's third round of bond purchases, known as quantitative easing or QE3, in September 2012. In contrast, average yields on investment-grade corporate bonds and high-yield bonds are 0.1% and 0.8% lower, respectively, over the same time period (as measured by Barclays index data)—clearly indicating which sectors of the bond market have been beneficiaries.

Assumed rates used in this publication are hypothetical and not representative of any actual interest rate. The Barclay's Aggregate Bond Index is unmanaged and cannot be invested into directly.

Some interest income is simply spent, but reinvestment maintains a steady source of demand. If we assume an average interest rate of 3%, below the 3.5% coupon rate of the Barclays Aggregate Bond Index, approximately $1.16 trillion (3% coupon rate multiplied on the total outstanding bond market size of $38.7 trillion) of interest income is generated each year, much of which will be reinvested in additional bonds. Absent the Fed, interest income alone could have absorbed most of the bond market growth that occurred in 2012.

It is not difficult to see how a favorable supply-demand dynamic supports the bond market. Add new money that flows into the bond market every month, along with Fed bond purchases and reinvestment demand, and the supply-demand backdrop improves further. Supply-demand factors are not the only driver of bond yields, but this dynamic should help limit any rise in bond yields.

The tight supply/strong demand that Fed bond purchases have helped engineer have benefited corporate sectors of the bond market. Average Treasury and mortgage-backed security (MBS) yields are higher now compared to just before the start of the Fed's third round of bond purchases, known as quantitative easing or QE3, in September 2012. In contrast, average yields on investment-grade corporate bonds and high-yield bonds are 0.1% and 0.8% lower, respectively, over the same time period (as measured by Barclays index data)—clearly indicating which sectors of the bond market have been beneficiaries. We still expect these higher yielding sectors to benefit investors over 2013 in what we still anticipate will be a range-bound, low-return environment for bond 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.

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.

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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

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.

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.

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 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 corporate sectors are Industrial, Utility, and Finance, which include both U.S. and non-U.S. corporations. The non-corporate sectors are Sovereign, Supranational, Foreign Agency, and Foreign Local Government. Bonds must have at least one year to final maturity, must be dollar-denominated and non-convertible, and must have at least $250 million par amount outstanding. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade.

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.

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 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).

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