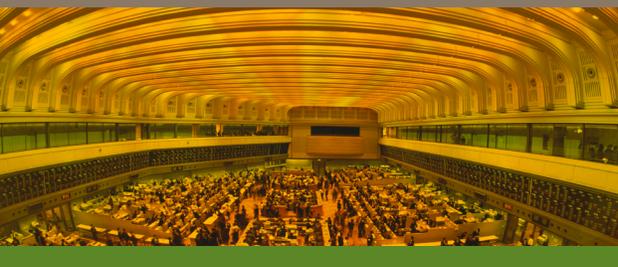


Bond Market Perspectives



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Back to the Future

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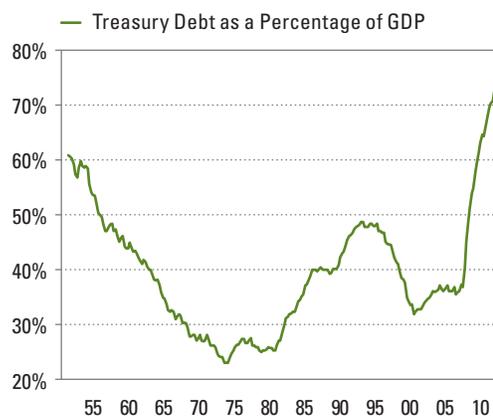
Highlights

We take a look back to the 1950s, which bears similarities to today's environment, to see what the future may hold for bond investors.

The rise in interest rates was gradual and included periods of losses but also periods of strength, highlighting that bonds can still play a role in a portfolio.

A low-return environment could likely be the norm, and the 1950s may provide a rough guide of what to expect.

1 The Post-War Period Was the Last Time the U.S. Faced a Large Debt Burden



Source: Haver Analytics 04/26/13

Note: Chart reflects marketable outstanding Treasury debt relative to the economy as measured by gross domestic product.

Mark Twain once stated that history does not repeat itself, but it often rhymes. In last week's commentary, we highlighted how several variables can play a role in assessing the impact of rising interest rates on investors' bond portfolios. Whether an investor experiences gains, losses, or merely low returns depends on maturity and sector exposure. This week, we take a look back to the past to see what the future may hold for bond investors, given the many uncertainties.

Our broad takeaway is that a low-return environment could likely be the norm, and the 1950s may provide a rough guide of what to expect. The monetary policy backdrop and bond market of the early 1950s bears some resemblance to today's environment.

In the late 1940s, the United States was in the process of paying down a large debt burden as a result of financing the war effort. The debt burden of the post-World War II era comes in second to today in terms of the amount of outstanding Treasury debt relative to the economy [Figure 1].

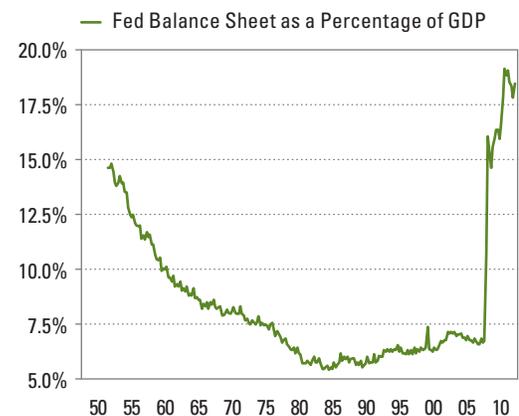
Similarly, the Federal Reserve (Fed) played a very active role with monetary policy in the post-war period. The Fed used interest rate caps to limit any potential rise in interest rates to facilitate paying down Treasury debt. Post-war Fed stimulus led to the Fed holding significant assets, which it gradually began to reduce throughout the 1950s. While the Fed continues to *increase* its assets now, also referred to as expanding the balance sheet, only the post-war period shows a similar magnitude of Fed assets relative to the size of the economy [Figure 2].

The Fed and the Treasury department agreed to end the interest rate cap of 2.5% on 10-year Treasury debt in 1951. However, the Fed, influenced by a strong U.S. Treasury, maintained a desire to keep interest rates relatively stable as long as inflation remained in check. Rather than hike interest rates after ending interest rate caps, the Fed relied on increasing or decreasing T-bill supply to loosen or tighten policy in order to transmit its desired impact on the economy. Today's Fed holds a similar desire to that of the late 1940s and continues to pressure interest rates lower indirectly via heavy Treasury bond purchases.

"Time Travel" Shows Interest Rates Rise Gradually

Low inflation and the Fed's desire to maintain stability helped foster a low-yield environment, but yields ultimately increased over the 1950s. However,

2 The Fed Was Reducing its Large Balance Sheet During the 1950s

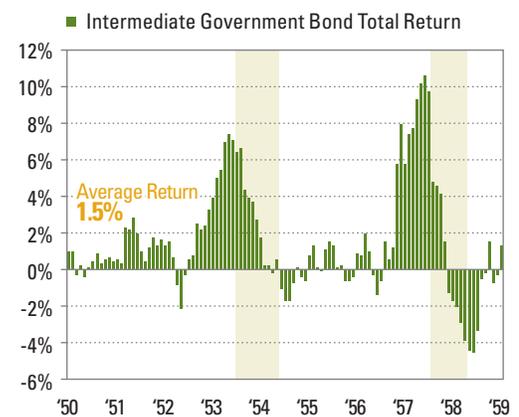


Source: Haver Analytics 04/26/13

Note: Chart shows size of the Federal Reserve's balance sheet relative to the economy as measured by gross domestic product.

While the Fed continues to *increase* its assets now, also referred to as expanding the balance sheet, only the post-war period shows a similar magnitude of Fed assets relative to the size of the economy.

3 The Low-Yield 1950s Was a Low-Return Environment Marked by Ups and Downs



Source: Ibbotson Intermediate Government Bond Total Return Index, LPL Financial 04/26/13

The Ibbotson Intermediate Government Bond Total Return Index is an unmanaged index and cannot be invested into directly. Past performance is no guarantee of future results.

Shaded areas indicate recession.

Rolling 12-month total returns.

the rise in interest rates was gradual with the 10-year Treasury beginning the decade with an approximate 2.4% yield, before closing the decade at a 4.7% yield, just over a two percentage point increase over a 10-year time horizon.

The 1950s witnessed periods of both bond market weakness and strength that ultimately translated into a low-return environment. The average 12-month total return of intermediate government bonds averaged 1.5% over the 1950s [Figure 3]. However, there were several periods of negative total returns, including a stretch where government bonds posted losses of just over 4% late in the decade. On the other hand, bond prices rose in anticipation of two recessions and led to bouts of higher returns peaking at over 10% at one point.

Insights for the Return Trip

The bond market of the 1950s, although certainly different, may provide some guidelines for today's investors:

- The climb to higher interest rates was a slow one. Despite the removal of the Fed's interest rate caps, Treasury yields did not spike higher, and the 10-year Treasury yield increased by just over two percentage points—but it took 10 years. While the Fed continues to buy Treasury bonds in an attempt to keep interest rates low, how quickly rates rise depends on the health of the broader economy and other macroeconomic risks (such as Europe). It is worth noting that over the 1960s, the 10-year Treasury rose by 2.2%, a similar amount, and it took another decade for the 10-year Treasury yield to rise another 2.4–10.3% before yields increased further at the start of the 1980s.
- Bonds can still play a role in investors' portfolios. The rise in interest rates was not a straight line and included periods of strength. Despite low yields, bond prices rose in anticipation of recessions and provided an offset to stock market declines during both recessionary periods. Since yields peaked on March 14, 2013, the broad Barclays Aggregate Bond Index is up 1.5% through April 26, 2013, as economic data have softened, raising concerns over the pace of future economic growth. Although stock prices have increased over the period, recent performance shows how bond prices, despite low yields, are still perceived as a safe haven. Nonetheless, we view the prospect of double-digit gains, as occurred in the late 1950s, as highly unlikely given today's lower level of yields. During the 1950s, the 10-year Treasury yield never declined below 2.2% in contrast to today's 1.7% yield.
- Low yields equal low returns and less downside protection. The low-yield environment provided less downside protection against rising interest rates, and periods of losses were evident over the 1950s. As highlighted in last week's *Bond Market Perspectives: Assessing Interest Rate Risk*, we believe a low-return environment will likely be the base case for investors in 2013 and likely longer, but investors should also be prepared for periods of potentially weaker performance or modest losses.



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Thankfully, today's bond market is much more diverse than that of the 1950s. The bond market consisted primarily of U.S. Treasuries in the 1950s in contrast to the much greater variety of bonds in the marketplace today, including much-improved access to foreign bonds. As we discussed last week, varying sector exposure can limit the impact of rising interest rates, which have historically impacted U.S. Treasuries most.

The 1950s, an environment with some similarities to today, show that low returns, rather than sharp losses, is likely the underlying theme for what bond investors can expect over the longer term. While the low-return environment can be unexciting and provides limited protection against inflation, segments of the bond market still play a role in investors' portfolios. ■



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.

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.

Bonds given an investment grade rating indicate a relatively low risk of default.

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

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.

Intermediate bonds are characterized by a maturity that is set to occur in the next three to 10 years.

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.

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.

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.

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.

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 Ibbotson U.S. Intermediate-Term Government Bond Index is measured using a one-bond portfolio with a maturity near five years.

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