Bond Market Perspectives

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Yield Shock

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Highlights

Yields rose across the bond market in recent days, as investors rebuked the low-yield world.

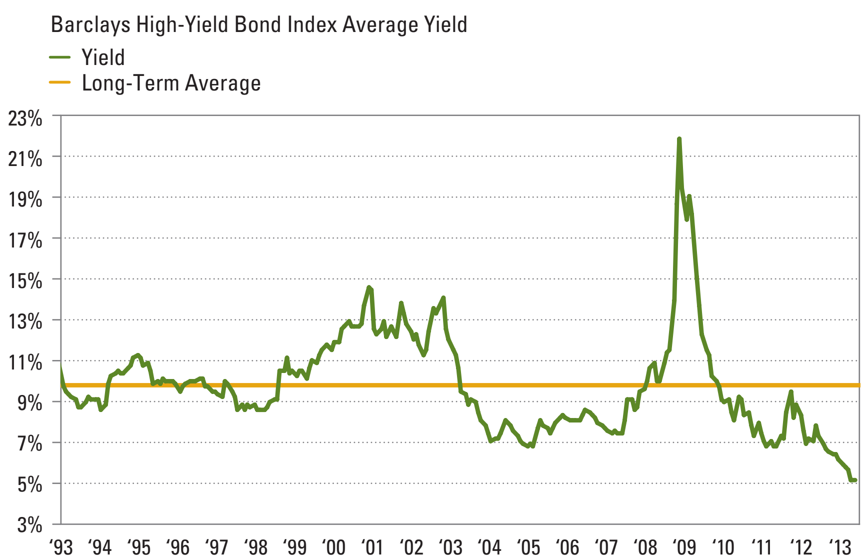
We view recent weakness as part of the checks and balances of healthy markets and still expect yields to be largely range-bound in 2013.

Yields rose across the bond market in recent days, as investors may have finally said "enough is enough" to low yields. Yields on several higher-yielding segments of the bond market at multi-year lows or, in the case of high-yield bonds, new record lows, reversed higher over the past two days (Friday, May 10 and Monday, May 13, 2013) as investors reassess valuations.

High-yield bonds witnessed a steady rise in price and corresponding decline in yield from mid-April 2013 to early May 2013. The average yield of the Barclays High-Yield Corporate Index declined from just over 5.5% to less than 5.0% this month [Figure 1]. This uninterrupted decline in yields matched the strength in the stock market as it moved to new highs. Although corporate defaults remain well below the long-term historical average, investors may have finally said, "enough," pushing yields higher by 0.2% over the two days ending Monday, May 13, 2013, leading to modest price declines. High-yield weakness was in contrast to the stock market, which witnessed stable-to-higher prices over the same period, as represented by the S&P 500.

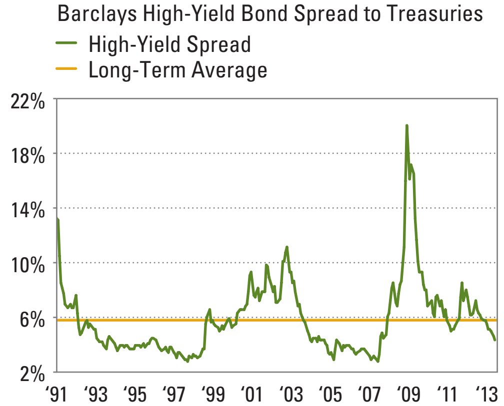
The decline in the average yield of high-yield bonds must be taken in context of record-, or near record-low yields across the bond market.

1 Investors Rejected a Brief Dip Below 5% Last Week



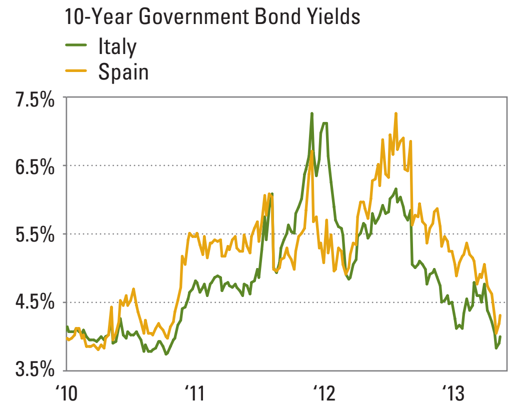
Source: Barclays, Bloomberg, LPL Financial 05/13/13

2 Yield Spreads Provide Important Context in a Low-Yield World



Source: Barclays, Bloomberg, LPL Financial 05/13/13

3 Spanish and Italian Government Bond Yields Backed Off Three-year Lows



Source: Bloomberg, LPL Financial 05/13/13

4 Treasury Yields May Retest the High End of the Range

Source: Bloomberg, LPL Financial 05/13/13

The decline in the average yield of high-yield bonds must be taken in context of record-, or near record-low yields across the bond market. A closer look at the average yield spread shows that valuations, as measured by yield spreads, are below the historic average but above the low point in spreads (highs in valuations) that occurred prior to the 2008 financial crisis and also the late 1990s [Figure 2]. The pullback in high-yield bonds over the past two days was likely due given recent strength, but the sector remains an alternative in a low-yield bond world.

Yield shock was also evident overseas in Spanish and Italian government bond yields. Both Spanish and Italian government bond yields fell sharply in April in anticipation of an interest rate cut and further monetary easing from the European Central Bank (ECB). After the ECB delivered on May 2, 2013, and appeared to leave the door open to further stimulus, bond investors similarly decided that enough was enough and that a 1% drop in Spanish and Italian 10-year government bond yields [Figure 3] to the lowest levels since the European debt problems first began to escalate in 2010 was too far too fast, given lingering economic problems.

High-quality bonds were not immune from the broad based sell-off either, as Treasury prices declined for a second consecutive week. After dropping to their lowest yields of 2013 at the end of April, Treasury yields resumed their ascent to the top end of the range [Figure 4], as low yields once again proved unpalatable. Improving economic data—a stronger employment report to start the month of May and better-than-expected retail sales on Monday, May 13, 2013—was the initial catalyst, with overseas-related weakness another driver.

Foreign Influences

Japanese government bonds (JGBs) continued to weaken in response to the Bank of Japan's (BoJ) unprecedented stimulus. Intermediate- to long-term JGB yields have increased by 0.20% to 0.25% since the end of April 2013, as investors anticipate higher growth and higher inflation. Japanese investors tend to look beyond JGBs an in attempt to boost ultra-low yields and the BoJ's recent stimulatory efforts have reinforced that phenomenon. JGB yields are still well below those of comparable Treasuries, but weakness in a high-quality government bond market such as Japan nonetheless weighed on Treasuries and caused investors to rethink lower yields.

Furthermore, yen currency weakness in response to BoJ actions has also played a role in Treasury price declines. One way Japanese investors have sought to boost yield over the years is with more exotic fixed income securities which are leveraged to the USD/JPY exchange rate. Without getting into the complexities of these securities, there often are some knock-on effects to the U.S. bond market. As the yen weakens, these notes are more likely to be redeemed earlier than expected and forces underwriters to unwind their interest rate hedges, forcing downward pressure on long-term Treasury prices, pushing yields higher. When the yen

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strengthens, the opposite can occur. Although inconsistent, these hedging flows have added to bouts of Treasury weakness in 2013. Further yen weakness may be a negative for Treasuries.

Checks and Balances

The extra yield of high-yield bonds in the context of a low-yield world can still potentially add value for bond investors.

Investor yield shock is part of a healthy market and part of a check and balance. We do not believe recent, but modest, high-yield weakness is the start of sustained sell-off due to low defaults and still-good underlying credit quality metrics. The decline in yields had gone too far too fast and was in part a rebuke to sub-5% yields. The extra yield of high-yield bonds in the context of a low-yield world can still potentially add value for bond investors.

The rise in government bond yields, be it riskier Spanish or Italian government bonds or higher-quality JGBs or Treasury bonds, suggests investors balked at yield levels in the former due to lingering European risks and in the latter due to improving growth expectations in Japan and the United States. One notable difference between the sell-off in JGBs and Treasuries is that the JGB weakness has come with rising inflation expectations, while U.S. Treasury weakness has been accompanied by only a minimal increase in inflation expectations. Without a sustained increase in inflation expectations, we continue to expect Treasury weakness to ultimately be contained and not mark the start of a sustained sell-off in bonds. ■

Structured notes may not be suitable for all investors and involve special risks such as risk associated with leveraging the investment, potential adverse market forces, regulatory changes, and potentially illiquidity. There is no assurance that the investment objective will be attained.

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.

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 Capital U.S. Corporate Index covers the universe of investment-grade rated corporate bonds issued by U.S. companies or specified foreign entities or corporations. Bonds must be U.S. dollar denominated, SEC registered, rated at Baa3/BBB- or better by at least two of the three major rating agencies (Moody's, S&P, Fitch) and have at least one-year remaining to maturity and at least $250 million outstanding. Convertible and floating rate bonds are not included.

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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