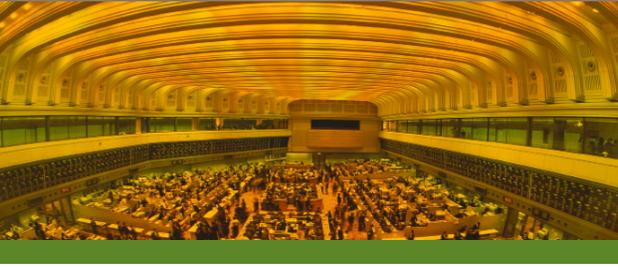


Bond Market Perspectives

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Highlights

Comparing municipal bonds to corporate bonds is another way to assess the value offered in the municipal bond market.

It is possible to view municipal bonds as better credit quality corporates with a tax exempt kicker.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

Moody's review still highlights how defaults on medium- to high-quality bonds are few and far between.

Municipal bonds are federally tax-free, but other state and local taxes may apply. Interest income may be subject to the alternative minimum tax.

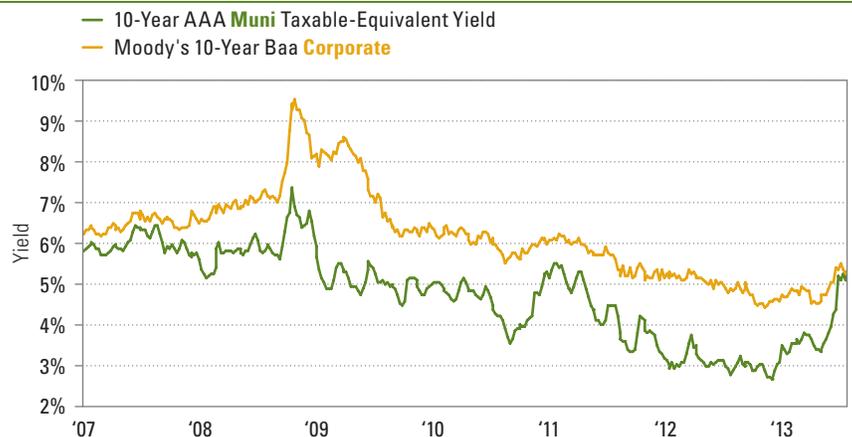
Municipals Versus Corporates

Comparing municipal bond yields to Treasury yields is a common way to assess municipal bond valuations, but comparisons to the corporate bond market can be another useful metric to gauge value. We often cite municipal-to-Treasury yield ratios as a key barometer of the attractiveness of municipal bonds. Like most investments, there is more than one way to gauge value and comparing municipal bonds to other taxable bonds, such as corporate bonds, is another way to evaluate the attractiveness of the municipal bond market.

Taxable bond buyers emerged last Friday, July 26, to take advantage of municipal bond valuations that compared favorably not only to Treasuries but also corporate bonds. Buying interest appeared following municipal bond underperformance to start last week that led to extreme valuations. Taxable bond buyers helped support the municipal bond market in late June 2013, when valuations reached similar levels.

Taxable bond buyers were lured in by compelling taxable-equivalent yields. The taxable-equivalent yield (TEY) of 10-year AAA-rated municipal bonds approached that of BBB-rated corporate bonds [Figure 1]. The near-similar yields, after accounting for the impact of taxes, show that current municipal bond pricing is depressed to the point that investors are disregarding credit quality differences. The last time the TEY of high-quality municipals and

1 Top-rated, Taxable-Equivalent Municipal Bond Yields Have Converged With Lower-Rated Corporate Bond Yields



Source: Bloomberg, LPL Financial, Moody's 07/29/13



2 Top Rated Municipal Yields Relative to Taxable High-Yield Bonds Near All-time High



Source: Barclays Index data, Bloomberg, LPL Financial 07/29/13

3 Municipals Have Exhibited Fewer Defaults for Comparably Rated Bonds

Average 10-Year Cumulative Default Rates (1970–2010)		
	Municipals	Corporates
Aaa	0.00%	0.50%
Aa	0.03%	0.54%
A	0.03%	2.05%
Baa	0.16%	4.85%
All Invst-Grade	0.06%	2.50%
Ba	2.80%	19.96%
B	12.40%	44.38%
Caa-C	11.60%	71.38%

Source: Moody's February 2011

With the Federal Reserve on pace to reduce bond purchases, we believe the path of interest rates will rise gradually providing a headwind to municipal bond performance.

middle-tier rated corporate bonds converged was in late 2010 and early 2011, following dire prognostications on the market from Meredith Whitney that induced a sell-off. Attractive valuations set the stage for price gains over the remainder of 2011.

Comparing the yield of highly rated municipal bonds to the taxable high-yield bond market also reveals the value in current municipal bond prices. The average yield of AAA-rated 10-year municipal bonds is almost half that of the broad high-yield corporate bond market, as measured by the Barclays High-Yield Corporate Index [Figure 2]. Similar to above, this metric shows the most attractive valuation of municipal bonds relative to lower-rated corporate bonds since the late 2010 and early 2011 period.

The metrics above show that municipal bond prices may have been inordinately punished and/or that investors are discounting the more favorable credit losses of municipal bonds. Municipal bonds have a long history of lower default rates. Moody's long-term study of municipal default rates reflects how similarly rated municipal debt exhibited fewer realized credit quality relative to corporate bonds [Figure 3]. Moody's updated the data earlier this year and noted that municipal defaults increased since their last comprehensive study, but remain low and represent just 0.03% of all Moody's rated issuers (over a one-year basis). Moody's states an average of 4.6 municipal issuers defaulted per year on average from 2008 through 2012. It is important to note that Moody's study covers only rated issuers. Non-rated issuers, which unsurprisingly comprise the bulk of historical defaults, are not included. Nonetheless, Moody's review still highlights how defaults on medium- to high-quality municipal bonds are few and far between. Highly publicized bankruptcies, like Detroit, will continue to garner attention but remain isolated events and not representative of the broader municipal bond market.

Setting Expectations

While municipal bond valuations are at their most attractive levels since the late 2010 and early 2011 period, we expect modest returns and not the 10.7% return posted by the Barclays Municipal Bond Index for 2011. The average yield to maturity of AAA-rated 10-year municipal bonds was roughly 0.5% higher in early 2011 versus current levels, and prices rose throughout steadily through much of the year as yields declined. With the Federal Reserve (Fed) on pace to reduce bond purchases, we believe the path of interest rates will rise gradually, providing a headwind to municipal bond performance. Municipal bond performance may be in the low-single digits at best. Still, the more attractive valuations provide a buffer as rates rise and may provide downside protection relative to other high-quality bond sectors.

We expect the municipal bond market recovery to be gradual and prospects of a quick, robust recovery appear limited. The supply-demand imbalance that has plagued the municipal bond market in recent weeks appears to be abating with new issuance dropping to a below average \$5 billion this week and secondary market selling on track to decrease for the first time in four weeks. This bodes well for further stabilization until more buyers, not just



taxable bond buyers, return to the municipal bond market. We continue to believe current municipal valuations provide an opportunity for patient bond investors and an attractive alternative to corporate bonds with the added benefit their tax exempt status kicked in for no additional cost. ■

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.

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.

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

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.

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.

Treasuries: A marketable, fixed-interest U.S. government debt security. Treasury bonds make interest payments semi-annually and the income that holders receive is only taxed at the federal level.

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INDEX DESCRIPTIONS

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 Capital 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.

This research material has been prepared by LPL Financial.

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