Bond Market Perspectives

August 6, 2013

It's a Grind

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Highlights

Bond market performance is still attempting to stabilize.

This week's auctions of longer-term, more interest rate sensitive 10- and 30-year Treasury may prove a good test of investor demand.

We believe consolidation in the bond market will set the stage for interest income to help offset losses from recent price declines.

After one of the worst quarterly sell-offs in years, the bond market has witnessed only mixed relief so far this summer. The high-quality bond market, as measured by the broad Barclays Capital U.S. Aggregate Bond Index, was roughly unchanged in July 2013, posting a modest 0.1% total return for the month. On the positive side, more economically sensitive sectors such as investment-grade corporate bonds, high-yield bonds, and bank loans bounced back firmly while municipal bonds continued to lag [Figure 1] as supply issues lingered.

1 July Performance Provided Only Mixed Relief Following a Difficult May and June

2013 Total Returns

Asset Class	July	YTD
Foreign Bonds (un-hedged)	2.0	-5.3
High-Yield	1.9	3.3
Bank Loans	1.1	3.5
Emerging Market Debt	1.0	-7.4
Investment-Grade Corporate	0.7	-2.9
TIPS	0.7	-6.7
Foreign Bonds (hedged)	0.5	0.5
Barclays Aggregate	**0.1**	**-2.3**
Treasury	-0.1	-2.2
Mortgage-Backed Securities	-0.1	-2.1
Preferred Stocks	-0.3	0.1
Municipal	-0.9	-3.5
Municipal High-Yield	-2.2	-4.3

Source: Barclays Capital, JP Morgan, BofA Merrill Lynch, and Citigroup Index 07/31/13.

Ranked by July returns.

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve.

All indexes are unmanaged. Past performance is no guarantee of future results. The returns do not reflect fees, sales charges, or expenses. The results don't reflect any particular investment.

Asset Class Indexes: Foreign Bonds (un-hedged)—Citigroup Non-US World Govt Bond Index (un-hedged); High-Yield—Barclays US High-Yield Corporate Index; Bank Loans—Barclays US High-Yield Loan Index; Emerging Market Debt—JP Morgan Emerging Markets Global Index; Investment-Grade Corporate—Barclays US Corporate Bond Index; TIPS—Barclays Treasury Inflation Protected Securities Index; Foreign Bonds (hedged)—Citigroup Non-US World Govt Bond Index Hedged for Currency; Treasury—Barclays US Treasury Index; Mortgage-Backed Securities—Barclays US MBS Index; Preferred Stocks—Merrill Lynch Preferred Stock Hybrid Index; Municipal—Barclays Municipal Bond Index; Municipal High-Yield—Barclays Municipal High-Yield Index.

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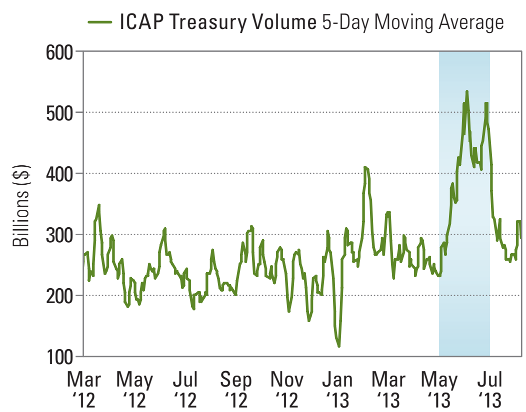
2 Buying Interest Has Emerged Twice Near the 2.75% Yield Level

Source: Bloomberg, LPL Financial 08/05/13

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.

3 After Surging During May and June, Treasury Volume Has Returned to More Normal Levels



Source: ICAP, Bloomberg, LPL Financial 08/05/13

Bond market performance is still attempting to stabilize and not yet ready to stage a broad-based rebound. We expect any rebound, should it materialize, to likely be limited unless corroborated with weaker economic data or signs the Federal Reserve (Fed) may hold off on its intention to reduce bond purchases. As a result, we believe bonds remain relatively range-bound over the remainder of 2013. July performance reveals that investors took advantage of cheaper valuations among investment-grade corporate bonds and high-yield bonds but were not yet ready to extend the buying interest to other sectors. Municipal bonds, the subject of several of our recent *Bond Market Perspectives*, witnessed bouts of buying interest, but nothing sustained, despite some of the most attractive valuations of the past several years as measured by municipal-to-Treasury yield ratios.

Treasury inflation-protected securities (TIPS) and emerging market debt also witnessed modest improvement in July but only recouped a small portion of May-June declines and were subject to volatile week-to-week swings. Both sectors are among the more interest rate sensitive in the bond market and the limited bounce reflects investor hesitancy.

Two factors suggest a tentative bottom may be in place and support more range-bound trading:

- **A successful retest of recent lows.** Yields approaching 2.75% on the 10-year Treasury yield have brought out buyers on two recent occasions. A soft jobs report sparked the strongest one-day rally in the bond market in over one year as investors viewed yields as too high given the economic data. High-quality bond prices declined heading into last week's employment report and the 10-year Treasury yield reached 2.71%, not far from the 2.75% peak of early July [Figure 2].
- **Lower volume.** Treasury volume has dropped back to average following a surge in May and June [Figure 3]. Some of the decline is attributable to a normal summer lull in trading, but the rush to sell bonds has diminished. The lack of top-tier economic data in the coming two weeks reduces catalysts for a potential surge in volume and renewed selling.

Auction Focus

This week's auction of 3-, 10-, and 30-year Treasury securities will be a focus in the absence of top-tier economic data. Auctions of longer-term, more interest rate sensitive 10- and 30-year Treasury bonds often prove a good test of investor demand. Good auction results will provide additional evidence that bonds may have stabilized and support the current yield range. Conversely, weak demand may bring about additional selling pressure that may bring still higher yields.

This week's auctions may provide a good gauge of sentiment given the improvement in demand at Treasury auctions in July. Auction demand can be assessed through a number of measures for each auction. The increase in "direct" bidder participation was the most notable difference between June and July Treasury auctions. Direct bidders represent both domestic and foreign buyers who place a "bid" for Treasuries directly rather than

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submit the request through one of the Fed's primary dealers—financial firms authorized by the Fed to make markets in Treasury securities and participate in every Treasury auction. A low amount of direct bids is indicative of weak demand and vice versa. The July increase in direct bids was likely a result of investment managers finding more value in the higher level of yields and increased purchases at auction.

Auction demand improved in July, but it was not at levels considered robust enough to spark a significant reversal. More consolidation may be needed in the bond market after a severe sell-off. Ultimately, we believe consolidation will set the stage for interest income to help offset the damage of recent price declines. We still expect the broad Barclays Capital U.S. Aggregate Bond Index to finish the year roughly flat but, as July performance shows, significant disparity between sectors may persist. Lower-rated, more economically sensitive bonds such as high-yield bonds and bank loans remain our focus.

Should the auction test pass smoothly, the lack of economic data and absence of a significant Fed meeting until late August reduces the number of potential market-moving catalysts. The relative quiet over the coming two weeks may lend further support to the existing range-bound environment and allow interest income to help bond investors grind out the difficult market environment. ■

High-yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio, as the principal is adjusted semiannually for inflation based on the Consumer Price Index (CPI)-while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of is that the CPI might not accurately match the general inflation rate; so the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPS do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Because of their narrow focus, sector investing will be subject to greater volatility than investing more broadly across many sectors and companies.

INDEX DESCRIPTIONS

The Barclays U.S. Corporate High Yield Index covers the USD-denominated, non-investment grade, fixed-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 Capital High Yield Index covers the universe of publicly issued debt obligations rated below investment-grade. Bonds must be rated below investment-grade or high-yield (Ba1/BB+ or lower), by at least two of the following ratings agencies: Moody's, S&P, Fitch. Bonds must also have at least one year to maturity, have at least $150 million in par value outstanding, and must be US dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

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).

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 JPMorgan Emerging Markets Bond Index Global ("EMBI Global") tracks total returns for traded external debt instruments in the emerging markets, and is an expanded version of the JPMorgan EMBI+. As with the EMBI+, the EMBI Global includes U.S. dollar-denominated Brady bonds, loans, and Eurobonds with an outstanding face value of at least $500 million. It covers more of the eligible instruments than the EMBI+ by relaxing somewhat the strict EMBI+ limits on secondary market trading liquidity.

The Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.

The Barclays 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.

The Barclays Capital High Yield Municipal Bond Index is an unmanaged index made up of bonds that are non-investment grade, unrated, or rated below Ba1 by Moody's Investors Service with a remaining maturity of at least one year.

The Citigroup World Government Bond Index is a market-capitalization-weighted index consisting of the government bond markets. Country eligibility is determined based on market capitalization and investability criteria. All issues have a remaining maturity of at least one year.

The Citigroup Non-U.S World Government Bond Index (Un-hedged) is calculated on a market-weighted basis and includes all fixed-rate bonds with a remaining maturity of one year or longer and with amounts outstanding of at least the equivalent of U.S. $25 million. The Index excludes floating or variable rate bonds, securities aimed principally at non-institutional investors and private placement-type securities.

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflation protected securities issued by the U.S. Treasury. The U.S. TIPS Index is a subset of the Global Inflation-Linked Index, with a 36.0% market value weight in the index (as of December 2007), but is not eligible for other nominal treasury or aggregate indices. In order to prevent the erosion of purchasing power, TIPS are indexed to the non-seasonally adjusted Consumer Price Index for All Urban Consumers, or the CPI-U (CPI).

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 Merrill Lynch Preferred Stock Hybrid Securities Index is an unmanaged index consisting of a set of investment-grade, exchange-traded preferred stocks with outstanding market values of at least $50 million that are covered by Merrill Lynch Fixed Income Research. The Index includes certain publicly issued, $25- and $100-par securities with at least one year to maturity.

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

RES 4289 0813
Tracking #1-190001 (Exp. 08/14)