Bond Market Perspectives

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Slowing Momentum

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Highlights

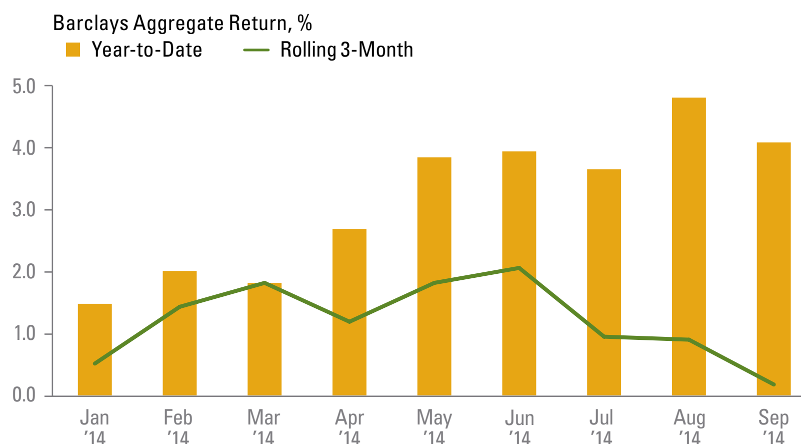
A challenging bond market environment will likely persist over the remainder of the year and perhaps beyond.

Valuations across many bond sectors remain above historical averages and reflect an expensive market.

We believe corporate bonds may provide investors with the best defense in what will likely be a continuation of the low-return environment.

The third quarter of 2014 may serve as a blueprint for what investors can expect over the fourth quarter. Bond performance slowed markedly after a strong first half of 2014, with the broad Barclays Aggregate Bond Index returning a scant 0.2% for the third quarter. Year-to-date bond performance is still firmly positive but has not materially improved since May 2014, and the three-month rolling return has decelerated reflecting the slower pace of returns [Figure 1]. As we highlighted in our *Mid-Year Outlook: The Investor's Almanac*, we believed bond performance would be roughly flat over the remainder of the year after a strong first half and we expect that trend to continue.

1 Bond Performance Slowed After a Strong First Half



Source: LPL Financial Research, Barclays Index data 09/30/14

Past performance is not indicative of future results.

Indexes are unmanaged and cannot be invested in directly.

Winners and Losers

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2 Winners and Losers Existed in a Low-Return Quarter for Bonds

Total Returns, %

Sector	Q3	YTD
Municipal High Yield	4.6	12.5
Foreign Bonds (hedged)	2.0	6.6
Municipal	1.5	7.6
Preferred Stocks	0.7	10.8
U.S. Treasuries	0.3	3.1
Mortgaged-Backed Securities	0.2	4.2
Barclays Aggregate	**0.2**	**4.1**
Investment-Grade Corporate	0.0	5.7
Bank Loans	-0.5	2.0
Emerging Market Debt	-1.7	7.3
High-Yield	-1.9	3.5
TIPS	-2.0	3.7
Foreign Bonds (unhedged)	-5.4	0.3

Source: LPL Financial Research Barclays Capital, JP Morgan, Citigroup 09/30/14

Ranked by Q3 total returns.

Past performance is not indicative of future results.

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

performance slowed as the Barclays U.S. Long Government/Credit Bond Index increased 1.0% over the third quarter—a sharp slowdown after the first two quarters of the year saw returns of 6.6% and 4.9%, respectively. A 1.0% gain does still show the power of bonds to provide diversification benefits during volatile periods, but stronger economic data in recent months have limited the lift geopolitical risks provide to bond prices.

Municipal bonds were one of the beneficiaries of long-term bond strength during the third quarter. On average the widely followed municipal bond indexes are generally longer maturity, including the Municipal Bond High Yield Index. The Municipal Bond High Yield Index was boosted by a rebound in Puerto Rican debt as most high-yield municipal bonds saw lesser gains. Despite modest weakness in September, a scarcity of supply continues to support municipal bonds.

At the other end of the maturity spectrum, short to intermediate bond prices were unchanged to slightly weaker. Most short-term bond prices declined and yields increased over the third quarter of 2014, a trend that has been in place for much of the year, as this portion of the market braces for an eventual Federal Reserve (Fed) interest rate increase in mid-2015.

Segments of the market, such as Treasury Inflation-Protected Securities (TIPS), high-yield bonds, bank loans, and emerging market debt (EMD), experienced outright declines [Figure 2]. TIPS suffered from declining inflation expectations as inflation measures decelerated and the Fed reiterated that inflation remains too low, while a poor September and a slew of negative news headlines hurt high-yield bonds, bank loans, and EMD.

Fourth Quarter Outlook

As we begin the fourth quarter of 2014, a challenging environment will likely persist over the remainder of the year and perhaps beyond. Valuations across many bond sectors remain above historical averages and reflect an expensive market. Bonds may remain expensive but high valuations will likely still limit opportunities for investors and perpetuate a low-return environment.

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Additionally, yields are near year-to-date lows and have priced in a lot of favorable news. Specifically, bond futures continue to reflect a first Fed interest rate hike during the summer of 2015, but a much more gradual pace of rate increases thereafter. Bond futures differ sharply from Fed forecasts. Although the Fed may in fact take longer to raise rates, that expectation was already prevalent throughout the third quarter. An additional catalyst would be needed to drive bond prices materially higher beyond the flattish 0.2% return of the third quarter.

So what is needed to drive bond prices materially higher? One, or a combination, of the following would likely be needed to spur additional gains:

- **Signs of an economic downturn or recession.** Most economic indicators continue to suggest the opposite—an expanding economy. Last Friday's stronger than expected monthly jobs report pressured bond

yields after geopolitical concerns drove prices higher early in the week. Employment data were the latest sign that fundamental conditions continue to reflect an economy that is growing at around a 3% pace.

- **Bond-friendly change in Fed policy.** The Fed remains on track to raise rates in summer 2015, but an indication that the Fed may push back the start of rate hikes may spur additional price gains as it delays a source of risk for the bond market.
- **Drop in domestic inflation.** Domestic inflation as measured by the Consumer Price Index (CPI) has decelerated after a spring increase. Deflation remains a risk in Europe and the recent strength of the U.S. dollar may also keep inflation low. As long as the economic expansion remains on track, and Fed policy accommodative, we believe the low in inflation was made early in 2014 and is unlikely to be revisited.

Beyond the factors above, a major geopolitical event with significant international repercussions could also drive bond prices higher. Such a move may be very short lived, however, and dependent on the extent of any economic disruption. Historically, geopolitical impacts have been short lived.

Corporate Opportunity

An increase in interest rates will cause the price of corporate bonds to decline. Corporate bonds are not secured by collateral and are subject to credit risk and default risk.

Some of September's laggards may provide the best opportunity in this challenging environment. A series of events has conspired against high-yield bonds (see the September 30, 2014, *Bond Market Perspectives*, "Late Summer Setback"). Most of them have been geopolitical, with airstrikes in Syria, protests in Hong Kong, conflict in Gaza, and renewed tensions in Russia-Ukraine sparking fears along with bad economic data in Europe. But in the United States the low default environment persists and the upcoming earnings season may continue to show that corporate credit quality remains strong, further bolstering the case for corporate bonds over the fourth quarter (please also see the October 6, 2014, *Weekly Market Commentary*, "Earnings Preview: Welcomed Opportunity to Focus on the Micro"). We believe these sectors allow investors the best defense in what will likely be a continuation of the low-return environment for fixed income. ■

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 reference is historical and is no guarantee of future results. All indexes are unmanaged and cannot be invested into directly. Index performance is not indicative of the performance of any investment.

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

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.

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.

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.

Stock and mutual fund investing involves risk including loss of principal.

Mortgage-backed security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by an accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Preferred stock, also called preferred shares or simply preferreds, is a special equity security that has properties of both an equity and a debt instrument and is generally considered a hybrid instrument. Preferreds are senior (i.e., higher ranking) to common stock, but are subordinate to bonds. Similar to bonds, preferred stocks are rated by the major credit rating companies. The rating for preferreds is generally lower since preferred dividends do not carry the same guarantees as interest payments from bonds and they are junior to all creditors.

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

INDEX DESCRIPTIONS

The Barclays U.S. Aggregate Bond Index is a broad-based index that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

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