Bond Market Perspectives

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Fixed Income Mid-Year Outlook: A Challenging Second Half Looms

Anthony Valeri, CFA
Market Strategist
LPL Financial

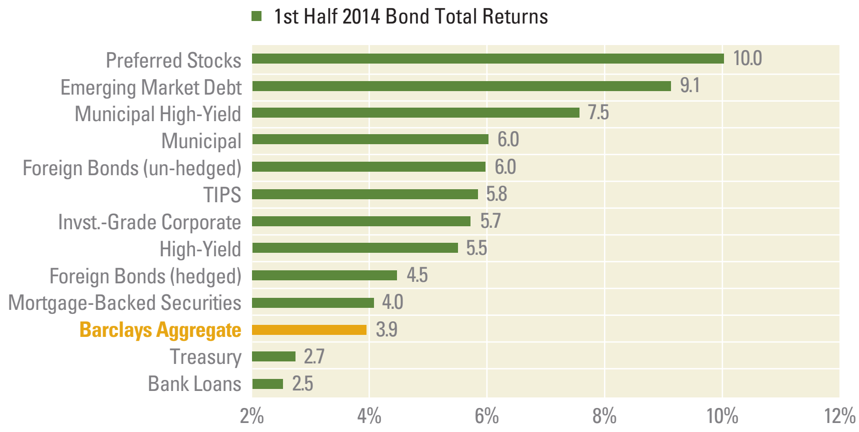
Highlights

After broad based strength over the first half of 2014, we expect yields may rise in the second half of 2014 as global growth strengthens and inflation picks up from recent lows.

Higher valuations have increased the challenges facing investors.

The first half of 2014 is now in the history books and was very kind to bond investors. The broad Barclays Aggregate Bond Index returned nearly 4%, but bond strength was broad based [Figure 1]. Within the bond market, longer-term bonds fared best, as they benefited most from price gains associated with lower market interest rates.

1 Bonds Enjoyed Broad-Based Gains During the First Half of 2014



Source: LPL Financial Research, Barclays, JPM, BofA Merrill Lynch, and Citigroup Index data 06/30/14

Opportunities in the bond market have become scarce as a result of first half strength. Current yields are unattractive, and gains are not likely in the second half. We find fewer sectors attractive compared to the beginning of the year. We expect yields may rise in the second half of 2014 as global growth strengthens and inflation picks up from the low point established in the first half.

Additionally, the bond market is mispriced for a normalization of interest rates by the Federal Reserve (Fed) and a gradual rise in inflation. In general, bond prices reflect an expectation that the Fed may raise interest rates very slowly and not as high as the Fed's own forecast. This has left bond prices very expensive relative to history. Bond prices may weaken over the remainder of 2014, leading to much lower returns, as investors demand higher yields in response to improving economic growth and to protect against an increase in inflation.

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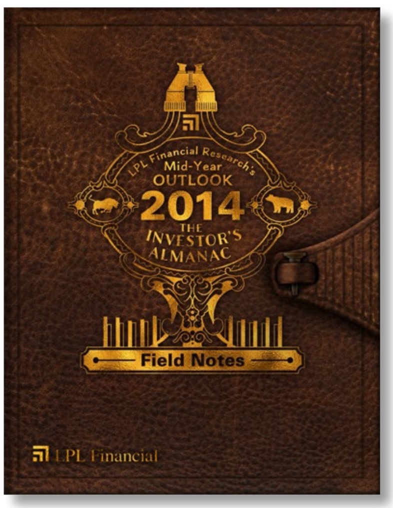

Risks

The primary risk to our outlook, the possibility that better growth in the economy and profits does not develop, has gained even sharper focus as we move into the back half of 2014. That risk is likely to be more significant in the second half of the year than the distractions posed by the end of the Fed's bond-buying program and the mid-term elections. Disruption to first quarter economic growth helped support bond prices and led to lower yields. A similar disappointment may keep bond prices and yields range bound for longer.

Corporate Bonds

The middle stage of the economic cycle is usually characterized by a healthy credit environment in corporate America. Credit quality, the ability to repay debt obligations, remains strong and supported by mid-to-high single-digit earnings growth by S&P 500 companies. Low interest rates have allowed corporate bond issuers to refinance debt, lower interest costs, and extend maturities—all of which have led to few defaults. In the United States, the dollar volume of defaults among speculative grade issuers remains near 1%, a level that bond rating agency Moody's forecasts is unlikely to change much over the coming year. Strong credit quality is a key fundamental support for corporate bonds and other economically sensitive fixed income sectors. However, credit spreads have narrowed, leaving price gains largely in the past. Now, typical to the middle stage of the cycle, the stable credit environment puts the focus of the bond market on yield.

High-yield corporate bonds have historically weathered rising interest rates better than most fixed income sectors during this stage of the economic cycle. Specifically, high-yield corporate bonds have often managed positive total returns during periods of rising interest rates due to their higher yields and moderate economic growth underpinning the creditworthiness of borrowers and keeping default losses low.

Challenges Ahead

Higher valuations, with bond sector yields near the low end of their ranges, have increased the challenges facing investors in the bond market and further support low return expectations [Figure 2]. Average yield spreads of several fixed income sectors are at the narrowest levels of the past four years. Investment-grade and high-yield corporate bond yield spreads are very near post-recession lows. Preferred security yield spreads are not far off post-recession lows, while emerging market debt (EMD) and mortgage-backed securities (MBS) are in the bottom half of their respective ranges. MBS spreads narrowed dramatically in late 2012 following the announcement of expanded Fed bond purchases. Absent the 2012 spike lower, MBS spreads, which are at their lowest levels of the year, would be near a post-recession low as well. EMD spreads recently closed at a one year low and a full percentage point below the early 2014 peaks. We would argue that both sectors are expensive relative to recent history and contribute to the value dilemma facing bond investors.

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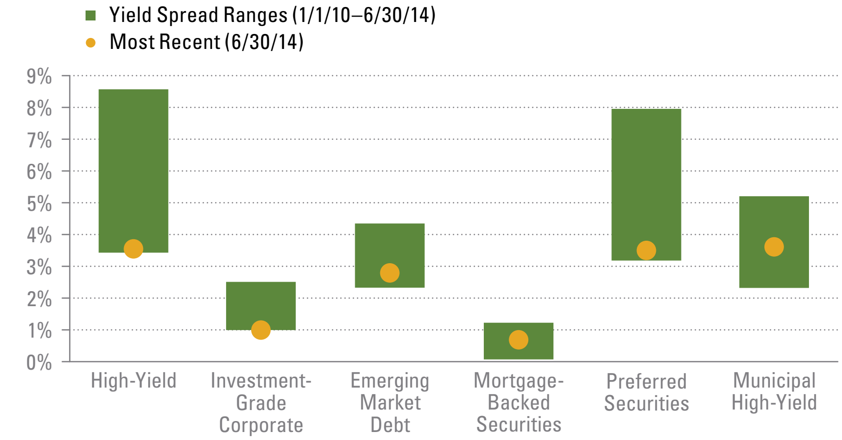
2 Most Segments of the Bond Market Are Expensive



Source: LPL Financial Research, Barclays High-Yield Index, Barclays Corp Index, JPM Emerging Markets Bond Index, BofA Merrill Lynch Hybrid Preferred Securities Index, Barclays High-Yield Municipal Index, Bloomberg 06/30/14

MBS yield spread is yield on "current coupon" FNMA securities minus 10-year Treasury yields.

Past performance is no guarantee of future results.

High-yield municipal valuations appear in the middle of the range and have not reached an extreme relative to taxable high-yield bonds. However, the inclusion of Puerto Rico debt, which is now over 20% of the municipal high-yield index, has distorted the average valuation, and yield spreads for the majority of the high-yield municipal bond market are much tighter.

Among taxable high-quality bonds, investment-grade corporate bonds may benefit from continued economic growth, but lower yields and a reduced yield premium, or spread, over comparable Treasury bonds suggest the sector will not be immune as interest rates rise. Similarly, lower yields and narrower yield differentials between high-quality municipal bonds and Treasuries indicate municipals may also be impacted by rising interest rates.

Higher valuations suggest total returns in the second half may be significantly lower than the first half of 2014 for all bond sectors, especially those more susceptible to interest rate risk. Overall, the appeal of high-quality bonds as investment options has diminished. As of June 30, 2014, the 2-year Treasury yielded only 0.2% more than the upper end of the Fed's current 0–0.25% range for the fed funds target rate. At the start of Fed interest hikes in the middle stage of prior cycles, this gap has historically averaged 1.0%, suggesting that short-term rates have room to rise. Higher short-term rates are likely to ripple across the maturity spectrum and push intermediate and longer-term yields higher, but likely not by the same magnitude.

Among high-quality bonds, shorter-term bonds with less sensitivity to rising interest rates may help buffer fixed income portfolios from price declines associated with rising interest rates. A combination of short- to intermediate-term bonds may provide portfolio diversification benefits while also providing less interest rate risk relative to the broad bond market, as measured by the Barclays US Aggregate Bond Index. ■

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 indices are unmanaged and cannot be invested into directly. Index performance is not indicative of the performance of any investment.

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

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