Bond Market Perspectives

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No Fooling, Good Quarter for Bonds

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Highlights

Bond prices rose across the board following a difficult 2013 and yields fell, with the 10-year Treasury yield closing the first quarter 0.3% lower.

At a 1.8% quarterly return for the Barclays Aggregate Bond Index, the pace of bond performance is unsustainable, and we continue to suggest a defensive posture against rising interest rates in the bond market with an emphasis on more economically sensitive sectors.

1 Bonds Enjoyed Broad-Based Gains During the First Quarter

Total Returns, %

Asset Class	1Q14
Preferred Stocks	6.5
Municipal High-Yield	5.9
Emerging Market Debt	3.5
Municipal Bonds	3.3
Foreign Bonds (unhedged)	3.2
High-Yield Corporate	3.0
Invst.-Grade Corporate	2.9
Foreign Bonds (hedged)	2.4
TIPS	2.0
Barclays Aggregate	1.8
Mortgage-Backed Securities	1.6
Treasuries	1.3
Bank Loans	1.1

Source: LPL Financial Research Barclays Capital, JP Morgan, Citigroup 03/31/14

Ranked by total returns.

Past performance is not indicative of future results.

Bonds actually matched the performance of stocks over the first quarter of 2014, contrary to many expectations at the start of the year. The broad Barclays Aggregate Bond Index finished the quarter with a 1.8% total return, equal to that of the S&P 500 Index after reinvestment of dividends. Bond prices rose across the board following a difficult 2013 and yields fell, with the 10-year Treasury yield closing the first quarter 0.3% lower. Stocks ran behind bonds for much of the first quarter, but a strong day for stocks on the last day of the quarter closed the gap.

Bond gains were broad-based with all segments of the bond market participating in strength [Figure 1]. Lower-rated, more economically sensitive sectors such as high-yield bonds shook off the growth uncertainties affecting stocks as investors focused on a low default environment and a still strong capability to repay debt obligations.

The drivers of bond returns are well-known but summarized below:

- **Weaker economic data.** Colder and snowier-than-usual weather impacted economic activity over the winter months. The degree to which weather has impacted economic data is unclear, but there is significant evidence from economic data releases, corporate earnings, and the Federal Reserve's (Fed) Beige Book of economic activity citing the impact of adverse weather.
- **Geopolitical uncertainty.** Treasuries historically benefit from the uncertainty arising from potential global conflict, and Ukraine-Russia tensions added to high-quality bond strength.
- **A reduction in Federal Reserve bond purchases.** Investors questioned the ability of the economy to stand on its own given the two factors above and the Fed's widely anticipated reduction of bond purchases. The

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

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Fed has steadily reduced its monthly bond purchases by $10 billion at the conclusion of each of its last three meetings, adding to investor nerves and helping to support bond prices.

Q2 Outlook

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At a 1.8% quarterly return for the Barclays Aggregate Bond Index, the pace of bond performance is unsustainable. Simple math would put the current pace on track for a high-single-digit return for the full year, a very difficult achievement for a still low yield environment. For bond prices to continue to rise and yields to fall, we would likely need to see one or both of the following outcomes:

1. **Persistent lackluster economic data.** A continuation of unimpressive economic data, or even the lack of a notable rebound, over the second quarter of 2014 would dispel the idea that soft data have been weather-related and suggest a more fundamental slowing of the economy.
2. **A Fed pause.** Should the Fed pause in reducing bond purchases, or push out its approximate timing of a first interest rate hike, bond prices may garner support from a more market-friendly Fed.

We expect economic data to improve and believe the odds of both outcomes above are low. The Fed has additionally indicated that a reduction in bond purchases may continue, and it is unlikely to alter its course absent a significant shift in the economy.

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Our expectation for a slowdown in performance applies to lower-rated bonds as well. We continue to believe high-yield bonds still offer yields that may buffer the impact of rising rates. However, with an average yield spread of 4% as of the end of Q1, high-yield bond prices have little room to improve further, and we expect interest income to be the primary driver of returns over the balance of 2014.

First Clues

The current week contains top-tier economic data that may reveal a slow emergence from winter-depressed economic data. As this publication goes to print, the Institute for Supply Management (ISM) manufacturing survey will be released, one of the best leading indicators of the economy, and the monthly jobs report is due out on Friday, April 4, 2014. Poor weather was evident in parts of the country during March but had less of an impact than the prior three months. Both reports should provide a better picture of the economy, but it may be early May and the next round of top-tier data before a clearer read is available. Until then, in the absence of confirmation of either a rebound in economic activity or additional slowing, bond prices and yields may remain range bound.

The 30-year Treasury bond may act as a leading indicator for the bond market, as it did in 2013.

2 A Break Below 3.5% May Signal Additional Bond Strength

Source: LPL Financial Research, Bloomberg 03/31/14

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The 30-year Treasury bond may act as a leading indicator for the bond market, as it did in 2013. The Barclays Aggregate Bond Index bottomed on September 5, 2013 following the severe bond market sell-off that began in May 2013, but the price of the 30-year Treasury bond bottomed two weeks earlier in late August [Figure 2]. The 30-year Treasury yield continues to hover just above 3.5%, the low end of a nine-month trading range, and a break below might signal additional bond market strength and in turn may lend support to intermediate- and short-term bond prices. Therefore, how the 3.5% yield level holds may be an important market signal, as a drop below would indicate the bond market sees greater economic concerns.

Conclusion

This week's set of top-tier economic reports may help resolve the question of weather-related distortions on the economy, but greater clarity may not arrive until May. Bond prices and yields may remain in their long-standing range until then, but a repeat of first quarter performance is unlikely. To show further strength, high-quality bond prices would probably need evidence of a Fed pause or further economic weakness, each of which has a low probability of occurring. We continue to favor lower-rated bonds. Although additional price gains for lower-rated bonds may be limited, higher interest income may help deliver a performance edge over the remainder of 2014. ■

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. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. Past performance is no guarantee of future results.

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.

The Fed funds rate is the interest rate on loans by the Fed to banks to meet reserve requirements.

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.

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.

Bank loans are loans issued by below investment grade companies for short term funding purposes with higher yield than short-term debt and involve interest rate, credit/default and liquidity risk.

INDEX DESCRIPTIONS

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 Bond 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 Bond 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 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.

J.P. Morgan Emerging Markets Bond Index Global (EMBI Global) tracks total returns for U.S. dollar denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, Eurobonds. Currently, the EMBI Global covers 188 instruments across 33 countries.

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 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 inflationprotected 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.

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