

Bond Market Perspectives



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Who's Your Friend?

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Highlights

All segments of the bond market benefited from the Fed's bond-friendly gestures last week.

Mortgage-Backed Securities stood out as a potential high-quality beneficiary, but more economically sensitive corporate bonds stand to benefit from the Fed's lower for longer approach.

1 The Fed's Bond-Friendly Approach Pushed Yields Back to the Low End of the Yield Range



Source: Bloomberg, LPL Financial 01/30/12

Last week, the Federal Reserve (Fed) signaled once again that it remains a friend to the bond market. At the conclusion of the Federal Open Market Committee (FOMC) meeting, the Fed announced it anticipated remaining on hold through at least "late 2014." Since the Fed is a primary driver of interest rates via its control over short-term lending rates, the forecast that interest rates would remain low for even longer than its previous mid-2013 timeline pushed the thought of interest rate risk even further back into the minds of bond investors.

Interestingly, prior to the FOMC announcement the bond market already expected a friendlier Fed, yet the news still had the effect of a powerful elixir. Fed Fund futures indicated that the Fed would not hike interest rates until June 2014, well beyond the stated mid-2013 objective. The delay to late 2014, even if modest, was enough to remind bond investors who their best buddy is.

But it did not stop there. During the subsequent press conference, Fed Chairman Ben Bernanke stated that additional bond purchases were "on the table," given only modest economic growth and still-high unemployment. In addition, the Fed stated an inflation target of 2%, the higher end of its previous 1.7%–2.0% target range. By pushing its tolerance for inflation slightly higher, the Fed signaled it may wait even longer before raising interest rates.

High-Quality Bonding

High-quality bonds rejoiced with broad-based strength that witnessed the high-quality bond market, as measured by the Barclays Aggregate Bond Index, reverse a small loss to start 2012 into a respectable gain of 0.5% through January 30, 2012. At this pace, the bond market will finish 2012 at the high end of our low-to-mid single-digit return forecast. For the week, the 10-year Treasury yield fell by 0.13% to 1.89%, back to the low end of the five-month trading range [Chart 1].

Cozying up to Mortgage-Backed Securities

By inching ever closer to another round of large-scale bond purchases, Mortgage-Backed Securities (MBS) may become the Fed's new best friend. MBS remain our favorite government bond sector, and the possibility of additional Fed purchases provides a favorable backdrop. Although the

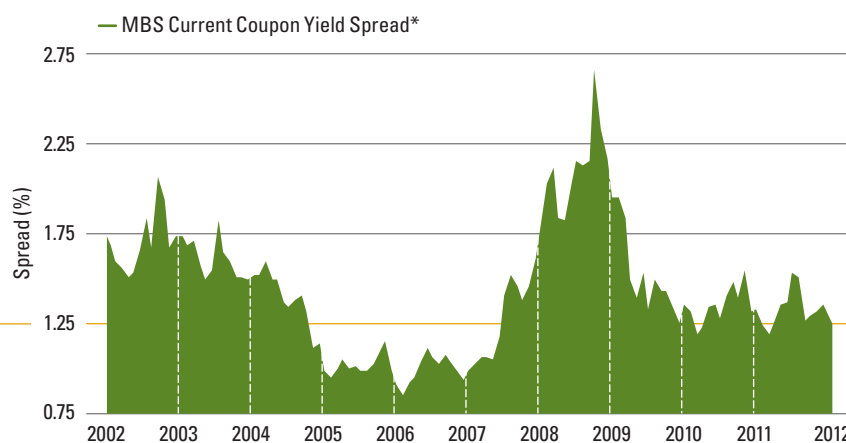


average MBS yield advantage to Treasuries decreased in recent weeks, partly in anticipation of an even friendlier Fed, the 1.25% yield advantage remains attractive particularly in a low-yield world. We would expect MBS prices to improve relative to Treasuries should the Fed follow through with additional MBS purchases. But if the Fed does not follow through, the 1.25% yield advantage is substantial [Chart 2]. While we continue to prefer investment-grade corporate bonds among high-quality bonds, MBS offer an attractive option for more conservative investors or those simply looking for protection in the event European news deteriorates.

2 MBS Possess a Considerable Yield Advantage Over Treasuries

1.25%
yield advantage

remains **attractive** particularly
in a low-yield world



Source: Bloomberg, LPL Financial 01/30/12

*Yield spread to blend of 5- and 10-year Treasury yield

The Fed “Friends” All Segments of the Bond Market

All segments of the bond market, not just government bonds, responded favorably to the Fed’s bond friendly gestures. Both investment-grade and high-yield corporate bonds responded strongly and actually outperformed Treasuries on the week. By reinforcing its commitment to be bond friendly, the Fed also reinforced some of the favorable credit-quality trends. Keeping interest rates lower for longer allows corporate bond issuers to continue to refinance higher cost debt and lower their interest expenses. According to Bloomberg data, 65% of last week’s high-yield new issuance was refinance-related in keeping with a long-standing trend. Refinancing purposes, not speculative leveraged buyout (LBO) related or other purposes, accounted for over 60% of high-yield bond new issuance in 2011.

The bond-friendly Fed helps explain why high-yield bonds continue to post positive returns over the three trading days ending Monday, January 30, 2012, despite the stock market, as measured by the S&P 500 Index, closing lower for three consecutive days.

Not all bond investors were charmed by the Fed’s latest moves. The Fed’s announcement that lifted prices and lowered yields complicated the task for



income-seeking investors. Nonetheless, we think income-oriented investors will benefit from the favorable credit quality trends outlined earlier. Stable credit quality along with less interest rate risk helps ensure price stability and reduces risks to bond holders. For our favorite income investment ideas, please see our recent *Search for Income* publication.

We were not surprised by the Fed's bond-friendly signals. The Fed has consistently shown a willingness to do more since the middle of last summer. While Treasury prices rose and yields fell last week, we do not view the Fed's action as strong enough to break the five-month trading range. We continue to view the 2% yield level on the benchmark 10-year Treasury yield as a center of gravity for the bond market and recent strength may fade. Interest income will likely continue to rule the day in that environment, and we remain focused on higher-income-producing bond sectors such as MBS, investment-grade and high-yield corporate bonds that also benefit from a low interest rate environment.

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.

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.

The Federal Open Market Committee (FOMC), a committee within the Federal Reserve System, is charged under the United States law with overseeing the nation's open market operations (i.e., the Fed's buying and selling of United States Treasury securities).

Barclays Aggregate Bond Index: is comprised of the Barclays Government/Corporate Bond Index, Mortgage-Backed Securities Index, and Asset-Backed Securities Index, including securities that are of investment-grade quality or better, have at least one year to maturity, and have an outstanding par value of at least \$100 million.

A Mortgage-Backed Security (MBS) is an asset-backed security whose cash flows are backed by the principal and interest payments of a set of mortgage loans. Payments are typically made monthly over the lifetime of the underlying loans.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

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.

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 (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.



Yield Curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth.

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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