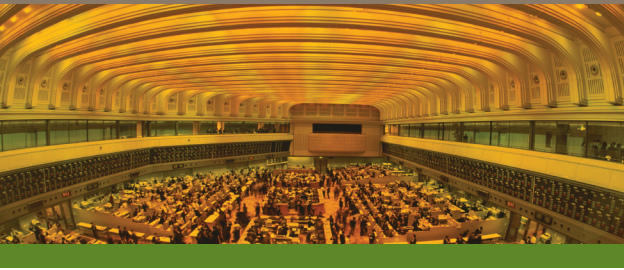


Bond Market Perspectives



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The Yield Effect

Anthony Valeri, CFA

Market Strategist
LPL Financial

Highlights

In the bond market, target yield levels can serve as a secondary factor that influences the performance of various bond sectors.

Bond investors should be aware of the key yield levels that can act as buying or selling points.

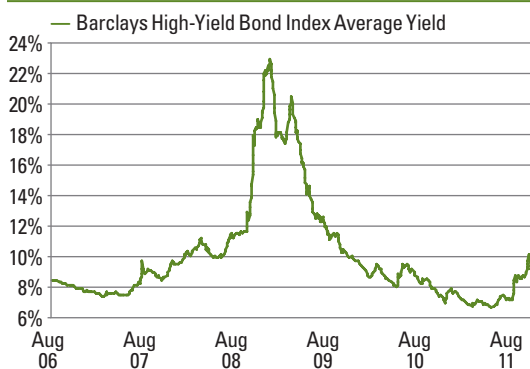
Yield can affect investor behavior and serve as turning points for the bond market and bond sectors. Yield is a driving factor for some investors who target specific yield levels before stepping in to buy, or sell, as the case may be. These investors oftentimes pay less attention to fundamental factors, and are willing to ride the ups and downs of the market as long as their target yield is locked in. We have frequently noted that economic growth, inflation, and Federal Reserve (Fed) policy are the primary driver of bond prices and yields. However, key yield levels can serve as a secondary factor to influence the performance of various bond sectors. Higher yields among certain sectors, in addition to better economic data and optimism over Europe, as discussed in last week's *Bond Market Perspectives*, "Bond Market U-Turn," acted as a catalyst and aided the recent bond market U-Turn.

The "yield effect" can be observed across a variety of bond sectors, but is most readily visible in the high-yield bond market. During the first few days of October 2011, the average yield of high-yield bonds eclipsed 10% [Chart 1]. The arrival of double-digit yields-for the first time in two years-garnered widespread investor attention, but not just from traditional bond investors. The 10% high-water mark brought about a flurry of buying and signified a whopping 9% yield advantage over the 5-year Treasury. Alas the 10% yield barrier was breached for only two days as investors realized that the yield was not only attractive on an absolute basis but also provided more than adequate compensation for a prospective increase in defaults even if the economy did fall into recession.

Investment-grade corporate bond yield also breached a key level around the same time as high-yield bonds. Buyers emerged when the average yield surpassed 4%. By itself, the 4% yield seems hardly exciting but must be taken in context and was more than double that of comparable Treasuries. Over the past year, the 4% yield level has sparked investor buying on several occasions [Chart 2] and led to firmer investment-grade corporate bond prices and lower yields. A strong start to earnings season has provided an extra boost to corporate bonds this October.

Delving deeper, the yield effect can be witnessed within the financial sector of the investment-grade corporate bond market. Concerns over the adverse impact that European government bonds may have on the banking sector, have impacted the bonds of financial issuers in particular. However, as the average yield of the Barclays U.S. Finance Index approached 5% [Chart 3], buyers emerged, and yields subsequently declined back to 4.5%.

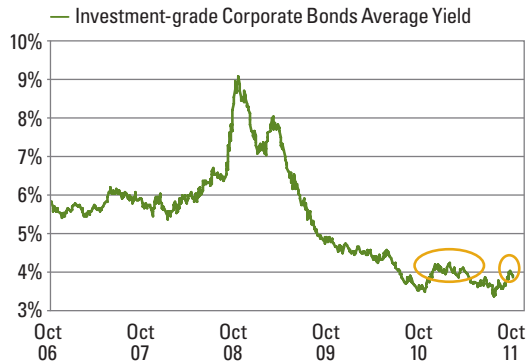
1 Buyers Emerged Once Average Yields Reached 10%



Source: Barclays, LPL Financial 10/24/11



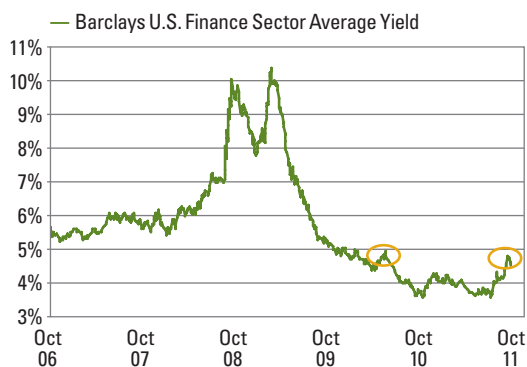
2 An Average Yield of 4% Has Sparked Interest in Corporate Bonds Over the Past Year



Source: Barclays, LPL Financial 10/24/11

Past performance is no guarantee of future results.

3 The Financial Sector's Average Yield Approaching 5% Also Brought Out Buyers



Source: Bloomberg, LPL Financial 10/14/11

4 An average 4.25% Yield Level on Long-term Municipals Has Historically Acted as a Brake on the Municipal Bond Market



Source: Municipal Market Advisors, LPL Financial 10/21/11

Coincidentally, yields on financial corporate issues had reached the highest level since spring 2010, the last time European debt fears escalated.

The yield effect can also have the opposite impact and lead to selling. The municipal bond market is dominated by investors who tend to be longer-term buyers and primarily focused on obtaining attractive tax-exempt income. Yield, therefore, is a primary driver of buying habits. As the average yield on long-term AAA-rated municipal bonds approaches 4.0%, municipal buyers hit the brakes [Chart 4]. As the chart illustrates the 4.25% level has served as a reversal point on several occasions. The approach of the 4.25% level has caused some municipal investors to wait on the sidelines for higher yields and helps explain why the municipal bond market has lagged Treasuries in recent weeks even though municipal bonds have increased in price. We do not view the decline in yields as reason to exit municipal bond positions but, as mentioned in previous publications, a factor to expect lower returns going forward.

Conversely, note how the 5% yield level has rarely been exceeded, with the exception of the disruption from the financial crisis, over the past 10-years. For many investors, a 5% yield represents the holy grail of municipal bond investing and translates into an after-tax yield of 7.6% for top 35% tax-bracket investors, without taking into account the benefit of state tax exemption, which would further boost the taxable equivalent yield.

Finally, record low Treasury yields have also motivated investors to sell. The 10-year Treasury yield was unable to sustain sub-2.0% yields witnessed during parts of September and early October 2011. Investors viewed the yield as too low if dire outcomes did not come to fruition. While the 10-year Treasury yield may drop below that threshold again in the future, it shows but without confirmation of still weaker economic data, lower inflation, or inaction on the part of European leaders, sub-2.0% 10-year Treasury yields may not be sustained.

Outright yield levels are not meant to replace the classic drivers of bond yields: economic growth, the Fed, and inflation. Nor are yields meant to replace traditional valuation analysis that includes comparing yield differentials between sectors or key benchmarks. The approach of key yield levels is worth noting however. It can motivate investors to get off the fence, triggering buys or sells that play a role in influencing bond performance.



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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.

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise, 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 a 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.

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.

An obligation rated 'AAA' has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

Yield is the income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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.

Barclays U.S. Finance Index is comprised of publicly issued investment-grade U.S. corporate bonds in the Finance sector. Bonds must have at least one year remaining to maturing and have at least \$250 million outstanding. Bonds must be rated investment-grade (Baa3/BBB-) or higher by two of the three major ratings agencies. Bonds must pay a fixed rate of interest, be U.S. dollar denominated, and non-convertible.

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