Bond Market Perspectives

August 16, 2011

Pessimism & Opportunity

Anthony Valeri, CFA
Market Strategist
LPL Financial

Highlights

Treasuries moved to price in a recession following a volatile week in financial markets.

Turmoil in Europe and recent action from the Federal Reserve (Fed) clouds interpretation but the Treasury market's pessimistic message is clear.

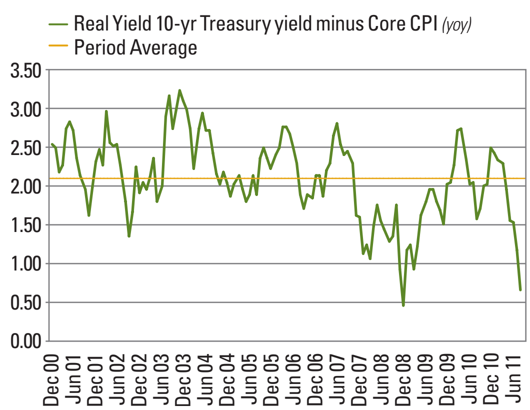
Recent Treasury strength provides opportunity in other areas: High-Yield bonds, Investment-Grade Corporate bonds, and Municipal bonds.

Treasuries moved to price in a recession following a volatile week in financial markets that led to strong safe-haven related gains. Turmoil in Europe and recent action from the Federal Reserve (Fed) clouds interpretation, but the Treasury market's pessimistic message is clear. The downgrade of Treasuries to AA+ proved to be inconsequential to bond investors as Treasury prices surged and yields fell by 0.1% to 0.3% across the maturity spectrum. The 10-year Treasury yield fell to within a few basis points of the 2.06% low achieved during the fall of 2008. Was the surge justified? Over the past 14 trading sessions, the price on the 10-year Treasury increased at a rate that would put the yield at a zero by mid-October. Such a pace is unsustainable and we believe the Treasury market may have overshot.

Treasury valuations, as measured by inflation adjusted yields, reached their most expensive levels since the peak of the financial crisis [Chart 1]. While we believe there is a small risk of recession, we certainly do not believe a repeat of 2008 is in store as we have discussed in previous publications.

The yield on the 10-year Treasury Inflation Protected Security (TIPS) declined to nearly 0.0% [Chart 2]. Since the total return of TIPS is comprised of both interest income (yield) and inflation compensation (as measured by the annual change in the consumer price index), the primary (and perhaps only) benefit from purchasing a 10-year TIPS at a zero yield would simply be inflation protection. In other words, 10-year TIPS pricing suggests minimal expectations for economic growth over the coming ten years.

1 Treasury Valuations are at Their Most Expensive Levels Since 2008



Source: Bloomberg, LPL Financial 8/15/11

The pessimistic growth outlook is confirmed by the modest decline in inflation expectations. Inflation expectations, as reflected in 10-year TIPS pricing, declined by only 0.2% in recent weeks, which tends to confirm the decline in 10-year TIPS yields towards 0.0% reflected investors dramatically ratcheting down economic growth expectations, not inflation expectations. This is in contrast to fall 2008 and also last summer, when TIPS prices indicated deflation was as a possible risk. To be sure, TIPS pricing can be influenced by specific market factors but not enough to offset the clear pessimistic message embedded in current TIPS pricing.

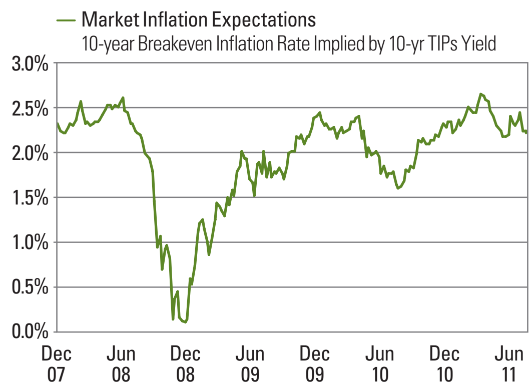
A Boost from Europe and the Fed

Treasury valuations are currently exacerbated by Europe and the Fed. As we highlighted last week, escalating concerns over European debt problems drove flows into Treasuries at the expense of German Bunds and the trend

2 TIPs Yields Imply Very Little Economic Growth Over the Coming Years…

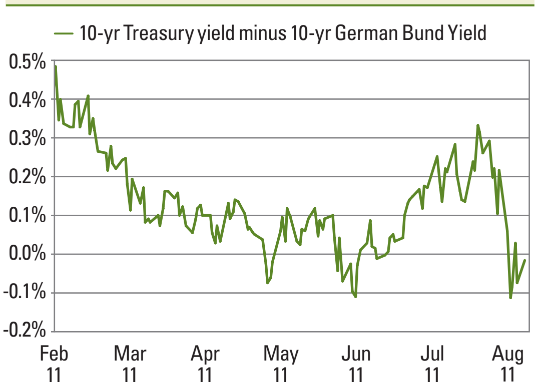
Source: Bloomberg, LPL Financial 8/15/11

3 …As Inflation Expectations are Only Slightly Lower



Source: Bloomberg, LPL Financial 8/15/11

4 Despite the Downgrade, Market Action Suggests Treasuries Remain the Preferred Safe-Haven



Source: Bloomberg, LPL Financial 08/15/11

continued last week. Treasuries have benefited as European investors look for a better safe haven [Chart 4].

Last week's Federal Open Markets Committee (FOMC) meeting concluded with the Fed announcing that interest rates will remain at their currently low level through mid-2013. The Fed has historically been a primary driver of interest rates due to its control over the Fed Funds rate, a benchmark overnight lending rate. By removing the threat of an interest rate hike for a period of almost two years, the Fed has dramatically reduced interest rate risk for bondholders. Treasury prices received additional support from the fact that short-term interest rates will be lower for a longer period of time than previously anticipated. Still, even with Treasury valuations receiving an extra boost from European investor flows and the Fed's on-hold-until-2013 message, we believe current valuations have factored in a return to recession.

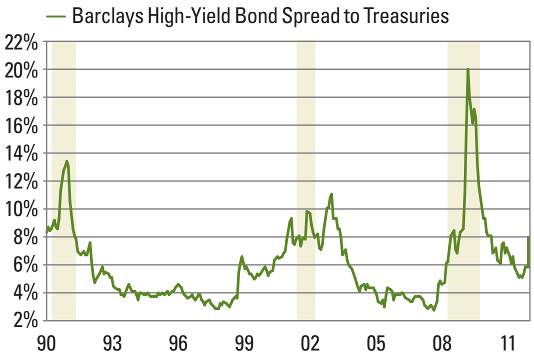
We believe the economy will avoid recession and recent market action has presented opportunities. A few sectors of the bond market stand out:

High-Yield bonds: Despite the volatility in the stock market, High-Yield bonds actually underperformed stocks last week. The S&P 500 Index declined 1.6% compared to a 2.9% drop for the Barclays High-Yield Index. High-Yield bonds have exhibited greater-than-normal sensitivity to stock prices recently. While this is not uncommon during periods of market volatility, we believe the extent of weakness in the High-Yield market is unjustified and an interest-bearing investment, even if lower rated, should not lag common stocks. With an average yield advantage of 7.6% above comparable Treasuries (as of August 12, 2011), the High-Yield market more than compensates for the current low 1.9% default rate and also compensates for a modest increase in defaults, something we do not expect to materialize unless the economy returns to recession. The current yield spread, also known as the risk premium, is approaching levels typically seen during recessions.

Investment-Grade Corporate bonds: Like their High-Yield cousins, Investment-Grade Corporate bonds suffered price declines last week on average but not nearly to the same degree. Still, the average yield advantage of higher-rated corporate bonds now stands at 2.0% above comparable Treasuries, well above the 1.3% long-term average and the highest level since June 2010. Much of the weakness is attributable to the financial sector but the entire sector has softened. We believe corporate issuers have done an excellent job of refinancing existing debt obligations and improving overall credit quality. Recent earnings reports indicate that fundamentals, and therefore debt service capability, remain strong. We believe the current risk premium of nearly 2.0% already accounts for a slowdown in corporate profitability during the third and fourth quarters of 2011. Although absolute yields remain low, the current yield advantage is significant in a low-yield world.

Municipal bonds: Unlike the fall of 2008, municipal bonds have increased in price during recent market volatility but failed to match the price gains of Treasuries. This is not uncommon during periods of strong safe-haven buying that benefits Treasuries far more than any other High-Quality Bond sector.

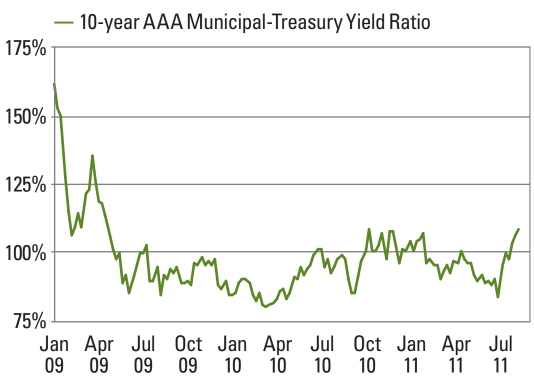
5 High-Yield Spreads are Approaching Recession-Like Levels



Source: Barclays Capital, LPL Financial 8/12/11

Shaded areas indicate recession

6 Top Quality Municipal Bond Yields are Higher Than Comparable Treasury Yields



Source: MMA, LPL Financial 8/12/11

However, it does provide an opportunity for High-Quality Bond investors. Average yields on AAA-rated municipal bonds are higher than Treasuries across the maturity spectrum. Visually, this is best represented when viewing municipal yields as a percentage of Treasury yields [Chart 6]. The higher the percentage the more attractive municipal bonds are relative to Treasuries and vice versa. Current ratios suggest municipal valuations are at their most attractive levels since early 2009. The caveat for municipal bonds, however, is the now lower level of yields. Lower yields imply lower returns going forward but it does not erase the value presented as a high-quality, tax-advantaged bond option.

Turmoil in Europe and recent Fed action exacerbated recent Treasury strength but the pessimistic message is clear. We acknowledge that the risks of recession have increased recently but still view recession as a low probability and we are biased to take advantage of the opportunities presented by recent market volatility.

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.

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.

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.

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.

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.

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.

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.

Credit Quality: One of the principal criteria for judging the investment quality of a bond or bond mutual fund. As the term implies, credit quality informs investors of a bond or bond portfolio’s credit worthiness, or risk of default.

International and emerging markets investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

The Standard & Poor’s 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Default Rate is the interest rate charged to a borrower when payments on a revolving line of credit are overdue. This higher rate is applied to outstanding balances in arrears in addition to the regular interest charges for the debt.

Yield Spread is the difference between yields on differing debt instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument. The spread can be measured between debt instruments of differing maturities, credit ratings and risk.

Treasury inflation-protected securities (TIPS) help eliminate inflation risk to your portfolio as the principal is adjusted semiannually for inflation based on the Consumer Price Index - while providing a real rate of return guaranteed by the U.S. Government.

The Barclays Capital High Yield 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 U.S. dollar denominated and non-convertible. Bonds issued by countries designated as emerging markets are excluded.

RES 3282 0811
Tracking #753330 (Exp. 08/12)