

Bond Market Perspectives

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Highlights

The high-yield bond market has priced in a surge of defaults over the coming year, an overly pessimistic assumption in our view.

Historically, defaults have never witnessed a back-to-back surge even in the event of a double-dip recession. Credit quality is better now compared to the start of the past two recessions.

Although recession risks have increased, we believe the economy will avoid recession and high-yield bonds provide a compelling opportunity.

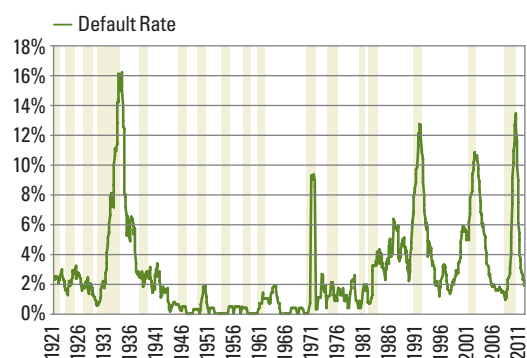
Is it Justified?

Investor pessimism is not just evident in ultra-low Treasury yields but also in economically-sensitive bond sectors, such as corporate bonds, and high-yield bonds in particular. In last week's publication we discussed the pessimistic implications embedded in current Treasury yields. This week, we take a closer look into the corporate sector. Both investment-grade and high-yield bonds are pricing in a significant probability of recession. But is it justified?

By taking the average price and average yield of the high-yield market, along with current Treasury yields, we can deduce what current market pricing is implying about future defaults. The implied future default rate on high-yield bonds is now 10% over the coming 12 months and over 40% over the coming 5 years. Such elevated default expectations are only witnessed during recessionary periods. Defaults over the past 12 months are currently running at a 1.9% annualized rate. Therefore, current market pricing is suggesting that defaults will accelerate sharply (to 10%) over the coming year.

We would logically expect defaults to increase if the economy indeed returned to recession but believe the 10% expectation is overly pessimistic. Historically, a surge in defaults has never been repeated [Chart 1]. The chart also reflects that while the economy has suffered a double-dip recession in the past, a double-spike in defaults has never occurred. The shortest period of time between the last two times defaults surpassed 10% was 7 years, the gap between the most recent recessions. Note that even during the Great Depression in the 1930s, defaults did not surge to their prior peak despite two back-to-back recessions. Therefore we view an acceleration of defaults to over 10% as highly unlikely.

1 A Back-to-Back Surge in Defaults Has Never Occurred



Source: Moody's, LPL Financial 08/19/11

(Shaded areas indicate recession)

One of the reasons defaults do not spike higher, even in the event of a double-dip recession, is that surviving companies are stronger. As defaults surge, companies take steps to reduce leverage and improve credit quality. This trend typically lasts a few years following a peak in defaults.

In addition, this most recent credit cycle has witnessed companies take advantage of low borrowing rates to refinance existing debt obligations. While investors can be dismayed by the low yields on high-quality bonds, it is a boon to corporate debt issuers who can reduce interest expenses and push out debt maturities farther into the future. According to S&P data, only \$52 billion in high-yield bonds mature through the end of 2012, a very small portion of a high-yield market value of more than \$930 billion (according to Barclays Index data). Historically, hostile market environments



have precluded corporations from accessing financial markets for funding or have forced issuers to pay much higher interest rates. Both factors have contributed to an increase in defaults but with so little debt maturing over the coming 15-months, a major source of potential default risk is vastly reduced. Corporations either do not have access to financial markets or can wait for a better opportunity.

Furthermore, as we highlighted in our August 2, 2011 *Bond Market Perspectives* “Downgrades & Deleveraging,” leverage in the financial system is greatly reduced. In 2008, leverage (the amount of borrowing, or debt, taken on relative to assets) was very high among traditional corporate bond issuers and contributed to a surge in defaults in 2009.

2 Credit Quality is Better Now

Credit Metric	Recession Start Month		
	Dec-07	Mar-01	Now?
Debt/EBITDA (Leverage)	4.1	3.4	3.3
Interest Coverage Ratio	4.2	5.9	10.6
Cash as % Debt	17%	16%	20%

Source: Factset, LPL Financial 08/19/11

Corporate credit quality metrics are better now compared to the last two recessions [Chart 2]. This will help corporate bonds better withstand a recession if it occurs. In the nearby table, we highlight three key credit metrics of S&P 500 companies as a proxy for broad credit quality trends. The amount of leverage is lower now compared to the previous two recessions. For leverage we compared the amount of debt relative to earnings as measured by earnings before interest taxes depreciation and amortization (EBITDA). The lower the ratio, the more revenue a company has at its disposal to service its debt obligations and vice versa. The ability to cover interest payments (interest coverage ratio) and cash relative to debt outstanding are also higher now than at the start of the prior recessions.

Risks

While we believe default risk embedded in current market pricing is overstated and corporations, on balance, are in better financial health compared to the start of previous recessions, there are still risks.

Most notably, valuations are attractive now and better than at the start of the Great Recession but not quite as attractive compared to valuations prevalent at the start of 2001 [Chart 3]. Given that corporations are healthier now compared to the start of prior recessions, we would expect valuations to be modestly more expensive. However, should an economic recession arrive, valuations would likely be pressured still lower simply due to the uncertainty over how much defaults may increase. Current yield spreads are also below the average that prevailed while the economy was actually in recession. While we believe the market has already more than factored in any likely increase in defaults, additional market weakness may create short-term losses for high-yield bond holders even if the longer-term opportunity remains compelling.

3 Valuations are Only Middle of the Road Compared to Past Two Recessions

	Recession Start Month		
	Dec-07	Mar-01	Now?
High-Yield Spread (%) at Recession Start	6.3	7.9	7.6
Average High-Yield Spread (%) During Subsequent Recession	11.7	8.2	na

Source: Barclays, LPL Financial 08/19/11



Recession risks have increased but we believe the economy will avoid recession. Default expectations embedded into current high-yield bond prices are overly pessimistic and contrasts with history of no back-to-back surge in defaults. Credit quality is better now and valuations are fair compared to prior recessions. We believe pessimism in the high-yield market has gone too far and presents an opportunity.

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.

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.

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.

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