Bond Market Perspectives

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Mixed Quarter for Bondholders

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Highlights

Performance between high-quality bonds and more economically sensitive bonds diverged during the third quarter.

Poor liquidity exacerbated weakness among high-yield bonds and other credit-sensitive bond sectors.

Yields on most Treasury securities do not provide protection against inflation.

We focus on the longer-term opportunity in more economically sensitive bond sectors but the coming two weeks may be critical.

The third quarter of 2011 was a mixed bag for bondholders with some economically sensitive bond sectors posting their worst quarterly performance since the third quarter of 2008 while Treasuries gained the most in price since the fourth quarter of 2008 [Chart 1]. While the magnitude of the performance disparity last quarter was nowhere near the magnitude of the fourth quarter of 2008, the drivers were similar: concerns over the economy and fears over the banking system. While U.S. banks and corporations are much healthier financially overall compared to 2008, the threat of contagion from Europe led to weakness for more economically sensitive bonds such as high-yield, preferred securities, and bank loans. Treasuries begin the fourth quarter of 2011 with more expensive valuations than during the fourth quarter of 2008 [Chart 2].

Nonetheless, Treasuries are likely to hold recent gains over the near term. Uncertainty over Europe remains high and financial markets are not convinced European policy makers have done enough to address the sovereign debt crisis. Although passage of the enhanced European Financial Stability Facility (EFSF) appears likely by mid-October, bond investors are looking for a more robust solution. European leaders have indicated that the next Group of 20 meeting in early November will be a target for announcing the plan. In the meantime, talks continue over whether Greece will receive the next tranche of aid. Failure to receive the scheduled payment could result in Greece defaulting. While a default is expected at some point by financial markets, the actual event may create knock-on events for European banks.

The decline in high-yield bond prices has been exacerbated by an illiquid trading environment.

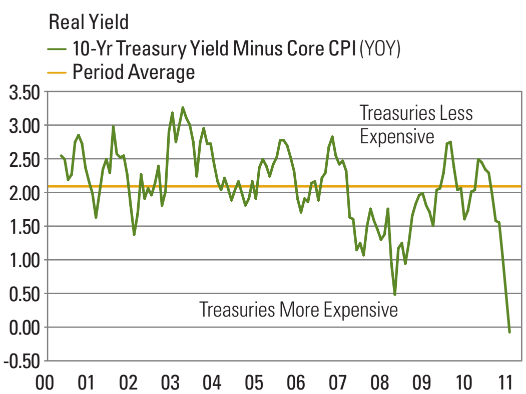
Keep in mind that expensive valuations did not stop Treasuries from posting strong gains during the third quarter thanks in part to a friendly Federal Reserve (Fed). At the August Federal Open Market Committee (FOMC) meeting Fed Chairman Bernanke surprised market participants by announcing the Fed will keep interest rates on hold through the middle of 2013. Then at the September FOMC meeting, the Fed followed up with a bold Operation Twist announcement as a second surprise. Bernanke and company at the Fed have left the door open for more unconventional policy steps and remain firmly accommodative. This week, the European Central Bank (ECB) may join the Fed in taking a more accommodative stance as futures market indicate a significant probability of an interest rate cut. Concerns over emerging market growth are leading to rising expectations of a rate reduction in China as well.

1 Third Quarter Year-to-date 2011 Fixed Income Sector Performance

Total Returns		
Sector	Q3	YTD
Treasury	6.5	8.8
TIPs	4.5	10.6
Barclays Aggregate	**3.8**	6.6
Municipal	3.8	8.4
Municipal High Yield	3.3	8.4
Invst.-Grade Corporate	3.0	6.5
Foreign Bonds (hedged)	3.0	3.4
Mortgaged-Backed Securities	2.4	5.3
Foreign Bonds (un-hedged)	1.0	5.7
Emerging Market Debt	-1.8	3.2
Preferred Stocks	-4.2	0.8
Bank Loans	-4.4	-2.0
High Yield	-6.1	-1.4

Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial
Ranked by 3rd Quarter Performance as of 09/30/11

2 Treasury Valuations Are More Expensive Now Compared to 2008



Source: Bloomberg, LPL Financial 10/03/11

Core CPI is a subset of the total Consumer Price Index (CPI) that excludes the highly volatile food and energy prices. It is released by the Bureau of Labor Statistics around the middle of each month. Compare to Personal Consumption Expenditures (PCE); Core PPI; Producer Price Index (PPI).

Uncertainty over Europe and friendly central bank policies are likely to keep high-quality bonds well supported over the near term but over the long term there is no denying the extreme lack of value in Treasuries. Most Treasuries fail to provide enough compensation to offset the impact of inflation [Chart 3] and may make for a very unappealing longer-term investment.

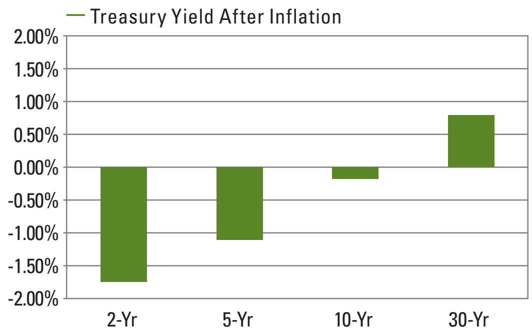
Even after a difficult quarter, we believe there is good value in high-yield bonds. The decline in high-yield bond prices has been exacerbated by an illiquid trading environment. After showing signs of stability from mid-August to mid-September, high-yield bonds suffered another bout of weakness over the final two weeks of September. We believe quarter-end pressures caused banks to take a conservative approach and withdraw further from participating in the high-yield market. At quarter-end banks will often clean up balance sheets for quarter-end reporting needs by reducing exposure to lower-rated bonds. With banks already reducing participation due to European uncertainty, quarter-end needs may have exacerbated illiquidity. Illiquid markets are one reason why high-yield bonds have diverged from stocks recently. Risk aversion is also elevated ahead of this week's full slate of top-tier economic reports, including monthly jobs report along with the ECB meeting. Over the coming two weeks, we are anticipating liquidity improving as the new quarter gets underway but should high-yield bonds fail to improve and continue to diverge from stocks we would view that as a more worrisome sign.

As mentioned in the August 23, 2011, *Bond Market Perspectives* publication, we continue to find compelling value in high-yield bonds as the market has priced in a more negative scenario than we believe is likely to occur. The fundamental factors highlighted in that publication remain very much valid today. As we argued back in August, we believe the implied rate of defaults is much higher than is likely to be realized. Should the economy enter recession we would expect defaults to increase to 4–6% over the coming year but not the 10%-plus default rate implied by current high-yield bond prices and yields. Furthermore, corporate bond fundamentals have never been stronger at the onset of a recession and may mitigate the magnitude of additional spread widening.

At a current yield spread of 8.9% above comparable Treasuries, high-yield valuations are in the highest quartile of observations over the history of the Barclays High-Yield Bond Index. The higher the yield spread the cheaper high-yield bonds valuations are and vice versa. Chart 4 shows the average excess return relative to Treasuries for the subsequent 12 months for given spread levels. Once yield spreads enter the highest quartile, high-yield bonds have outperformed Treasuries over the next 12 months by over 8% on average.

Such longer-term opportunity does not rule out additional near-term weakness, however. Illiquid trading conditions can exacerbate price declines and cause markets to disconnect from fundamental data. It could be a bumpy ride for investors over the coming weeks as investors look for clarity from Europe and upcoming economic reports.

3 Most Treasury Yields Do Not Compensate for Inflation



Source: Bloomberg, LPL Financial 10/3/11

Chart shows current Treasury yields after subtracting current annualized rate of inflation as measured by the core consumer price index (CPI).

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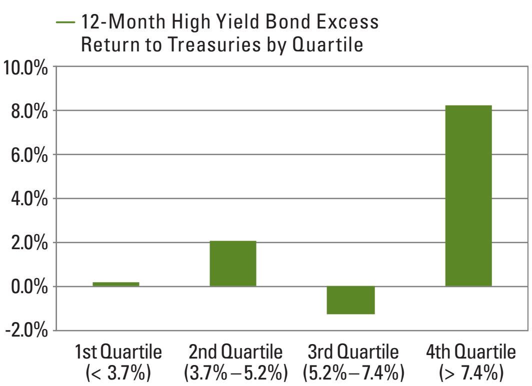
4 Current High-Yield Bond Spreads Bode Well for Future Returns



Source: Barclays High-Yield Bond Index monthly data from January 1988–August 2010. Percentages reflect yield spread range for each quartile

Emerging market bonds were resilient in August during the initial downdraft in the markets but came under pressure in September as economic growth fears extended to faster-growing developing economies. Questions about emerging market growth have centered on China and how much the economy may decelerate. Emerging market debt valuations have reached the most attractive levels since June 2009. We believe emerging market growth fears may be exacerbated, and like domestic high-yield, price in a more negative outcome than is likely than is likely to be realized.

Concerns over financial companies drove preferred securities weakness during the third quarter. Roughly 80% of the preferred securities market is comprised of financial issuers. While the growth outlook for many financial issuers may be low, we believe their ability to continue to service debt payments remains strong. We believe most domestic financial institutions have sufficient capital reserves to absorb a potential Greek default.

Although the third quarter of 2011 was difficult for many bond investors, we continue to find the most value in the downtrodden sectors. We find Treasuries a very unattractive long-term investment but the sector may hold recent gains over the near term as uncertainty remains high. The coming two weeks may be critical due to key economic data releases and central bank meetings in Europe. Should liquidity deteriorate further, we may shift our focus to more high-quality bonds as a temporary precaution. In the meantime, we continue to focus on the longer-term horizon and more potentially attractive investment opportunities in high-yield bonds and other economically sensitive bond sectors that we believe have been unfairly punished in the short term.

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.

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.

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.

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors is the premier forum for our international economic development that promotes open and constructive discussion between industrial and emerging-market countries on key issues related to global economic stability. By contributing to the strengthening of the international financial architecture and providing opportunities for dialogue on national policies, international co-operation, and international financial institutions, the G-20 helps to support growth and development across the globe.

The Federal Open Market Committee action known as Operation Twist began in 1961. The intent was to flatten the yield curve in order to promote capital inflows and strengthen the dollar. The Fed utilized open market operations to shorten the maturity of public debt in the open market. The action has subsequently been reexamined in isolation and found to have been more effective than originally thought. As a result of this reappraisal, similar action has been suggested as an alternative to quantitative easing by central banks.

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.

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, and 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.

This Barclays Aggregate Bond Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment-grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

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