

Bond Market Perspectives



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Bruised Bank Loans

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Highlights

The Bank Loan sector disappointed investors in August in what was a mixed bag for bond performance overall.

A few factors coincided to exacerbate recent Bank Loan weakness.

Depressed Bank Loan prices offer opportunity going forward.

The Bank Loan sector disappointed investors in August 2011 in what was a mixed bag for bond performance overall. August witnessed the greatest performance disparity between Treasuries and more economically sensitive bond sectors, such as corporate bonds, since the fall of 2008. Such disparities are rare, but occur during periods of extreme safe-haven buying where investors favor Treasuries above all else. Bank Loans underperformed high-yield bonds in August despite the fact that bank loans are shorter-term in nature and senior to high-yield bond obligations in a company's debt hierarchy. Several factors compounded Bank Loan weakness in what was a difficult August for corporate bonds overall.

After a difficult start to August, the August 9 Federal Open Markets Committee (FOMC) meeting accelerated selling. The Fed's commitment not to raise interest rates before mid-2013 reduced a potential positive catalyst for bank loan investors. The benefit of an adjustable interest rate, which delivers more income to investors as interest rates rise, was essentially negated for the foreseeable future. While the Fed was not expected to raise interest rates for almost year, at the earliest, the announcement of being on hold for nearly two years caused investors to question the benefit of holding an adjustable rate fixed-income security.

The Fed's enhanced on-hold message exacerbated Bank Loan selling. Bank Loans had been under selling pressure throughout August due to heightened risk aversion and volatile markets as evidenced by steady mutual fund outflows. However, mid-August witnessed a record \$2.1 billion outflow from bank loan, or floating-rate, mutual funds. The record outflow followed a hefty \$1.5 billion outflow the prior week and late August witnessed an additional \$944 million outflow according to Lipper data, an industry based source for mutual fund flow data.

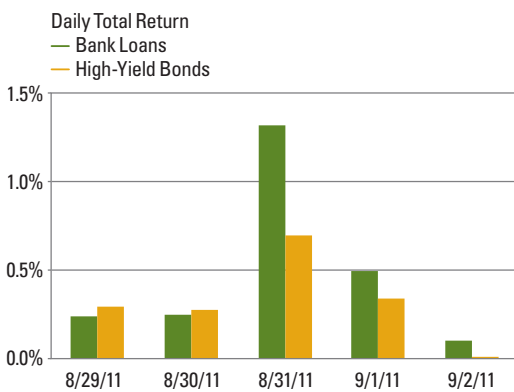
Fund outflows coincided with a typically illiquid period for Bank Loans. Next to the final week of the year, the final two weeks of August are typically the quietest weeks of the year for bond trading, particularly Bank Loans and High-Yield Bonds. Market liquidity was already poor due to a tough start to August, but the typical late summer lull likely exacerbated price declines while selling pressure remained extreme. This supply-demand imbalance is similar to the pressure the municipal bond market suffered during fall of last year.

The supply-demand factors overpowered still favorable fundamental factors. Defaults remain very low by historical standards amounting to 1.4% over the



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1 Bank Loans Outperformed High-Yield Bonds Last Week



Source: Barclays, S&P, LPL Financial 09/02/11

past 12-months according to Moody’s. We believe the recent decline in bank loan pricing has more than factored in a rise in defaults. The average bank loan trades at a price of \$90.4, according to Barclays High-Yield Loan Index data, nearly a 10% discount to par value. Such an average price implies a much greater potential increase in defaults than we believe is likely to occur. The decline in average price has increased the average current yield, now approximately 5% by our calculations. While that yield is notably below the average yield of the High-Yield Bond sector, it is much higher than many other sectors of the bond market and stands out in a low-yield world.

Although bank loan interest payments may not increase anytime soon, depressed prices provide an opportunity. Last week, credit markets experienced a reprieve and rebounded. Low prices attracted buyers and the bank loan sector outperformed high-yield bonds on the week [Chart 1]. Should recession fears or worries over Europe abate, we believe still depressed bank loan prices provide as much, or equal, opportunity as high-yield bonds. In the event that investors’ fears either persist or intensify, we believe the more discounted average price of bank loans may provide better downside protection.

Going forward, we believe fears over Europe and recession here in the United States may keep credit markets under pressure. Exiting the market briefly to avoid further weakness is tempting, but timing could be difficult. We believe the bank loan market has priced in a greater-than-expected increase in defaults than is likely to occur and therefore, like other segments of the corporate bond market, offers a compelling 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.

Floating rate bank loans are loans issued by below investment grade companies for short term funding purposes with higher yield than short-term debt and involve risk.

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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