

Bond Market Perspectives



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A Look Back, A Look Ahead

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Highlights

High-quality bonds posted impressive performance in 2011 as Europe dominated investors' attention and two classic drivers of bond yields—the Fed and inflation—took a back seat.

For 2012, lower yields imply lower returns but high-quality bonds are likely to hold firm until clarity emerges on how successfully European bond issuers are able to refinance maturing debt.

In 2011, high-quality bonds posted their strongest calendar year performance since 2002. Last year's high-quality bond performance, as a whole, was even better than 2008 when Treasury prices soared in response to the financial crisis. The main difference in 2011 was the better performance of investment-grade corporate bonds, which increased in price compared to notable price declines in 2008. Make no doubt about it, however, Treasuries stole the show in 2011 and led performance [Chart 1] with price strength evident by the 1.4% decline in the 10-year Treasury yield, from 3.3% to 1.9%. Intermediate Treasury yields start 2012 at the lowest levels since the early 1950s.

Last year's Treasury strength defied bond market history as it took place without the help of Federal Reserve (Fed) rate cuts or a decline in inflation, two classic drivers of interest rates. To be sure, the Federal Reserve was still active but in an unconventional way. During the first half of 2011, the Fed was active with the second large-scale bond purchase program, known as QE2, and in September, the Fed announced Operation Twist, which focused Treasury purchases on longer 20- to 30-year bonds. Still, intermediate Treasury yields increased by 0.6% to 0.8% during QE2, and Operation Twist, although ongoing, has so far witnessed little change in Treasury yields. We believe these programs have had only a minor impact on Treasury yields overall, although we believe Operations Twist may ultimately prove more impactful for long-term Treasuries.

Perhaps the Fed's most impactful 2011 move was the announcement to keep interest rates low through the middle of 2013. This unprecedented step greatly reduced interest rate risk for intermediate and long-term Treasuries and helped boost prices.

Core inflation more than doubled in 2011 from very low levels but investors chose to focus on disappointing economic data for much of the year. Prospects for domestic economic growth improved over the final months of 2011 but Europe continued to exert an extraordinary amount of influence on Treasuries [Chart 2].

The traditional drivers of bond prices and yields took a back seat to Europe and the ongoing European debt problem. Although Treasuries were downgraded by S&P in August to AA+ they remain the best house on a bad block. Bond investors seeking to avoid Europe with other top-quality bonds have little alternative to Treasuries and other U.S. government guaranteed bonds issued by Fannie Mae, Ginnie Mae, and Freddie Mac. All AAA-rated



1 Treasury strength powered high-quality bond returns in 2011

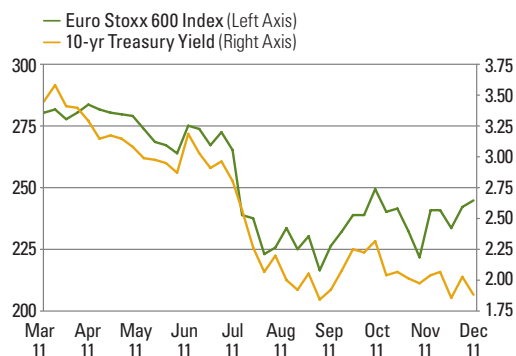
TOTAL RETURNS

Sector	2011
TIPs	13.6
Municipal	10.7
Treasury	9.8
Municipal High Yield	9.3
Emerging Market Debt	8.5
Invst.-Grade Corporate	8.4
Barclays Aggregate	7.8
Mortgaged-Backed Securities	6.2
Foreign Bonds (un-hedged)	5.2
High Yield	5.0
Foreign Bonds (hedged)	4.0
Preferred Stocks	1.9
Bank Loans	1.1

Source: Barclays Capital, JP Morgan, Citigroup, LPL Financial 12/31/11

Asset class returns are represented by the returns of indexes and are not ranked on an annual total return basis. It is not possible to invest directly in an index so these are not actual results an investor would achieve. TIPs – Barclays Treasury Inflation Protected Securities Index; Treasury – Barclays US Treasury Index; Municipal – Barclays Municipal Bond Index; Emerging Market Debt – JP Morgan Emerging Markets Global Index; Invst-Grade Corporate – Barclays US Corporate Bond Index; Mortgage-Backed Securities - Barclays US MBS Index; Foreign Bonds (un-hedged) – Citigroup Non-US World Govt Bond Index (un-hedged); High-Yield – Barclays US High Yield Corporate Index Foreign Bonds (hedged) - Citigroup Non-US World Govt Bond Index (hedged); Preferred Stocks – Merrill Lynch Preferred Stock Hybrid Index; Bank Loans – Barclays US High-Yield Loan Index.

2 Europe Was the Dominant Driver of High-Quality Bond Performance in 2011



Source: Bloomberg, LPL Financial 12/31/11

European government bonds are currently under review for a downgrade by S&P, and both Moody’s and Fitch have threatened downgrades as well.

Not only did Europe pose a risk to the global financial system but European debt problems continue to exacerbate a growing issue for bond investors—the lack of top-quality bonds. The supply of AAA-rated bonds continues to shrink. Over the past ten years, the percentage of AAA-rated bond issuers in the Barclays Global Aggregate Bond Index has shrunk from 75% to 50%. Among domestic corporate bond issuers, only four remain AAA-rated (versus six 10 years ago). In addition to European concerns, Treasuries, at least for now, continue to benefit from a perceived shortage of top-quality bond options.

Looking forward to 2012, the challenge posed by Europe will be most evident in the refinancing needs of European government bonds and European bank bonds [Chart 3]. The ability of France, Spain, and Italy, as well as large European banks, to rollover maturing debt will be a crucial test of whether recent measures by EU leaders, and the European Central Bank (ECB) with its new 3-year lending facility, will prove satisfactory.

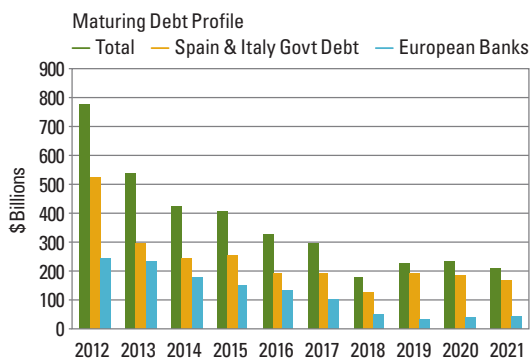
The traditional drivers of bond prices and yields took a back seat to Europe and the ongoing European debt problem. Although Treasuries were downgraded by S&P in August to AA+ they remain the best house on a bad block. Bond investors seeking to avoid Europe with other top-quality bonds have little alternative to Treasuries and other U.S. government guaranteed bonds issued by Fannie Mae, Ginnie Mae, and Freddie Mac. All AAA-rated European government bonds are currently under review for a downgrade by S&P, and both Moody’s and Fitch have threatened downgrades as well.

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The 2011 decline in intermediate Treasury yields was the greatest since 1995. The drivers of performance in 1995 and 2011 were very different however. Treasuries started 1995 with cheap valuations as investors were overly concerned about rising inflation. Inflation fears failed to materialize and bonds received an added boost from the Fed which lowered short-term borrowing rates twice during the year. In contrast, 2011 began with

3 In 2012, Europe's Ability to Rollover Maturing Debt Will be a Key Test for Financial Markets



Source: Bloomberg, LPL Financial 12/31/11

Note: European Bank debt profile consists of maturing debt of 11 large European banks (Deutsche Bank, Commerzbank, BNP, Credit Agricole, Societe Generale, Banco Santander, Banco Bilbao, Banco Popular, Unicredito, Intesa San Paolo, and Monte dei Paschi).

expensive Treasury valuations but closed with even more expensive valuations, as measured by inflation-adjusted yields. The 1.9% 10-year Treasury yield close at the end of December 2011 was below the 2.2% annualized rate of core inflation. The last time the bond market witnessed such a phenomenon was in late 1970s/early 1980s. European debt concerns and the lack of high-quality alternatives mentioned earlier explain the still higher valuations.

The high valuations and now lower yields [Chart 4] imply that 2012 will deliver lower returns for bond investors. We believe record low Treasury yields will prove unsustainable over the intermediate and longer-term due to our belief the economy will avoid recession and deflation is unlikely to occur. Nonetheless, high-quality bonds are likely to remain expensive until the success (or lack thereof) of European bond auctions becomes clear. For 2012, our primary focus remains on the bond market segment which witnessed a modest increase in yield during 2011 while maintaining a very stable credit quality profile: high-yield bonds. For high-quality bonds our emphasis remains on investment-grade corporate bonds and municipal bonds, and to a lesser extent government agency mortgage-backed securities (MBS), where better valuations and modestly higher yields may buffer against a modest rise in interest rates we expect later in 2012.

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.

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.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values and yields will decline as interest rates rise and bonds are subject to availability and change in price.

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.

Quantitative Easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

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.

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 fund shares is not guaranteed and will fluctuate.

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