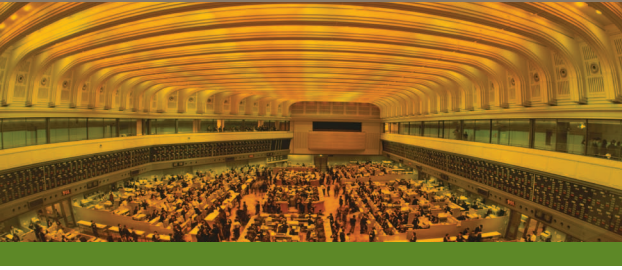


Bond Market Perspectives



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Made-for-TV Government Bonds

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Highlights

U.S. Treasuries have benefited from European government bond drama despite challenges of their own such as the debt ceiling and decreased foreign purchases.

Treasury yields are likely to stay near current levels until European drama subsides.

It used to be that the bond market was that quiet segment of financial markets and received little attention compared to stocks and other investments that offered higher returns. Daily and weekly movements of stocks would garner most of the attention. Over the course of a full week, the yield on the 10-year Treasury note might change by 0.08% with a price change of 11/32nds. Big deal! Most investors typically were not interested unless they could receive a tidy 7% yield. Until then, only sexier investments, such as stocks, would make the headlines or be worthy of cocktail hour chatter. That's no longer the case.

Leading "Must-See" Actors

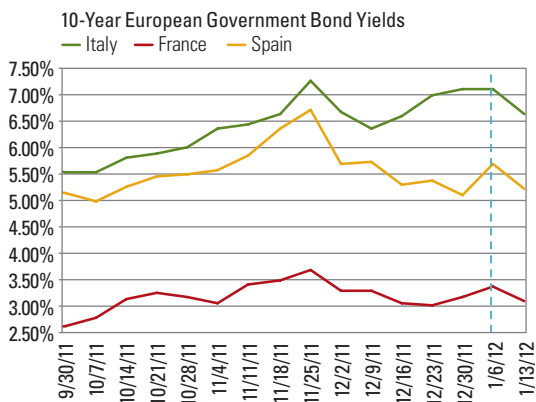
Today's global bond market comes with the drama of a soap opera and hysterics of a reality TV show. The lead actors in this new Made-for-TV government bond market are the European government bond markets. It seemed fitting that last Friday, January 13, 2012, the day that France and Austria lost their coveted AAA-rating from Standard & Poor's Ratings Services (S&P), coincided with the 43-year run of "One Life to Live," the well-known soap opera and a hallmark of daytime TV, coming to an end. It appeared the soap couldn't compete with European government bond markets.

Downgrades were not limited to France and Austria, which are now rated AA+. S&P downgraded Portugal, Spain, and Italy two notches to BB, A, and BBB+, respectively. The ratings downgrades follow S&P's December 5, 2011 announcement placing 15 Eurozone countries on review for possible downgrade. Back in December, S&P added that the ratings review would be completed "as soon as possible," as if to tease market participants about the next episode and keep viewers on the edge of their seats. Hopefully, no one held their breath.

Audience Has Relatively Muted Response to Ratings Downgrades

Despite the dramatic ratings action, the audience was not as shocked and market reaction to the downgrades was relatively muted. The U.S. stock market, as measured by the S&P 500, declined by 0.5% and the Euro Stoxx 600, a measure of European stock markets, declined by only 0.1%. More specifically, French, Italian, and Spanish 10-year government yields finished higher by only 0.03%, 0.01%, and 0.09%, respectively. Furthermore, Credit

1 Key European Yields Declined Last Week Despite Ratings Downgrades



Source: Bloomberg, LPL Financial 01/13/12

Past performance is no guarantee of future results.



Default Swaps (CDS) for France, Italy, and Spain, which measure the cost to insure against default and are often the first to move in response to perceived credit quality changes, finished the day unchanged. In fact for the week, CDS spreads for the downgraded issuers actually decreased in concert with a notable decline in their 10-year yields as well. The market viewed less risk with France, Italy, and Spain over the course of the full week.

The muted market reaction to the negative ratings news can also be attributed to offsetting positive news from earlier last week. Like any good TV drama, there is conflicting news to challenge the viewer about what comes next. Prior to the downgrade news, both Spain and Italy successfully auctioned new bonds in their first note auctions of 2012. The auction results were a sign that the European Central Bank's (ECB) recently enacted 3-year borrowing facility is easing funding strains and sparking demand. Spain's results were particularly impressive, as it was able to sell more than the intended amount of bonds, and its 5-year note auction was two-times oversubscribed. In addition, Fitch Ratings, which along with S&P and Moody's comprise the three major U.S. ratings agencies, stated that France was unlikely to lose its AAA-rating during 2012 in a classic "he said, she-said" TV controversy.

Where Will the Next Twist Take Us?

Investors shouldn't be lulled by last Friday's muted reaction. Like any good TV drama, sub-plots set up the next twist and turn, and one in particular is brewing for upcoming episodes.

Negotiations between Greece and private bondholders of Greek government bonds over the proposed debt exchange broke down last week. Greece and EU (European Union) leaders are trying to force bondholders to take a greater loss than the initially proposed 50% or, alternatively, take a lower interest rate on new bonds that will replace existing debt as Greece attempts to reduce its debt burden. Without private bondholders, a group that includes a few large and influential hedge funds, agreeing to a debt-exchange, Greece will not be able to meaningfully reduce its debt load. If an agreement is not reached, then a default may occur by mid-March when a large bond payment is due. Another risk emerges should EU leaders force private holders to take losses while the ECB's Greek government bond holdings are unaffected. Bondholders may perceive their holdings of government bonds, be it Greece, Italy, whomever, as subordinated to ECB holdings. In this way, large scale ECB bond buying, which has played a beneficial role, may actually discourage European bond investment if investors fear losses will be thrust upon them just to keep ECB holdings unaffected.

All the European government bond drama has shifted viewer attention to Treasuries, the clean-cut neighbor down the street with troubles of its own but still charming enough to investors. U.S. Treasuries continued to benefit from Europe's debt woes, and yields declined by 0.04% to 0.11% last week. The 10-year Treasury yield closed the week at the low end of a 4-month trading range [Chart 2].

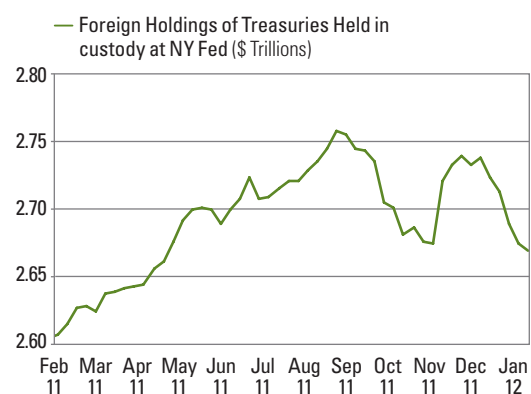
2 Treasuries Continue to Benefit From European Drama



Source: Bloomberg, LPL Financial 01/13/12



3 A Strong US Dollar is Likely Responsible for a Slowdown in Foreign Buying



Source: Federal Reserve, LPL Financial 01/11/12

Like its European counterparts down the block, the Treasury market has its own set of sub-plots to keep viewers on the edge of their seats in coming weeks and months.

- The Debt Ceiling.** It's back! The Treasury has once again reached the debt ceiling, but unlike last August, the debt ceiling does not coincide with a government shutdown. The debt ceiling will be raised but not without some political theater first. On January 18, 2011, Congress will hear President Obama's request to formally increase the debt limit by \$1.2 trillion. The House will likely reject the measure in a symbolic move first, and then President Obama will override Congress by using his veto power to get the \$1.2 trillion debt limit increase needed. The ultimate outcome is already well-known, but why make it boring along the way?
- Foreigners scale back.** Foreign buying of U.S. Treasuries has fallen sharply in recent weeks [Chart 3]. A continued decline in foreign buying habits could capture the market's attention since foreigners hold roughly half of U.S. Treasury debt. The recent slowdown in purchases is likely the result of a strong U.S. dollar. The U.S. Dollar appreciated by just over 7% against a basket of foreign currencies over the final four months of 2011, sparking losses on foreign holdings of Treasuries. Countries may simply be pausing Treasury purchases in a simple risk-control measure, but given U.S. dependence on foreign buying this sub-plot may garner increasing attention in coming weeks and months.

No doubt about it, government bond markets have managed to garner a lot of attention recently and done so in a low yield world, an impressive achievement. For this, European government bond markets were robbed of a best actor award at this past weekend's Golden Globe Awards, with Treasuries missing out on a supporting role award. High-drama is likely to persist, however, with a series of European summits and high-level meetings in coming weeks along with an expected increase in new bond auctions starting in February. During this time, Treasuries, despite their expensive valuations, are likely to benefit with the 10-year yield remaining near its center of gravity of a 2.0% yield.

We will be watching European auction results closely as well as the potential resolution of the Greek debt exchange in coming weeks. Success on both fronts may pressure Treasury yields higher. In the event of no resolution, a significant maturing Greek bond payment in mid-March may create the next sub-plot in the European government bond drama. You just can't make this stuff up.



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.

A Credit Default Swap (CDS) is designed to transfer the credit exposure of fixed income products between parties. The buyer of a credit swap receives credit protection, whereas the seller of the swap guarantees the credit worthiness of the product. By doing this, the risk of default is transferred from the holder of the fixed income security to the seller of the swap.

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.

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.

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.

An obligation rated 'AA' differs from the highest-rated obligations only to a small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

An obligation rated 'BB' is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

An obligation rated 'B' is more vulnerable to nonpayment than obligations rated 'BB', but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid, and small capitalization companies across 18 countries of the European region: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

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.

Credit Quality is 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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