LPL RESEARCH

BOND MARKET PERSPECTIVES

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HIGH-YIELD: CAUTIOUSLY OPTIMISTIC

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KEY TAKEAWAYS

High-yield's impressive year-to-date performance has left the market on the expensive side of fair value and susceptible to pullbacks related to equity market or oil weakness.

The high-yield market has already priced in much of the good news regarding decreasing defaults.

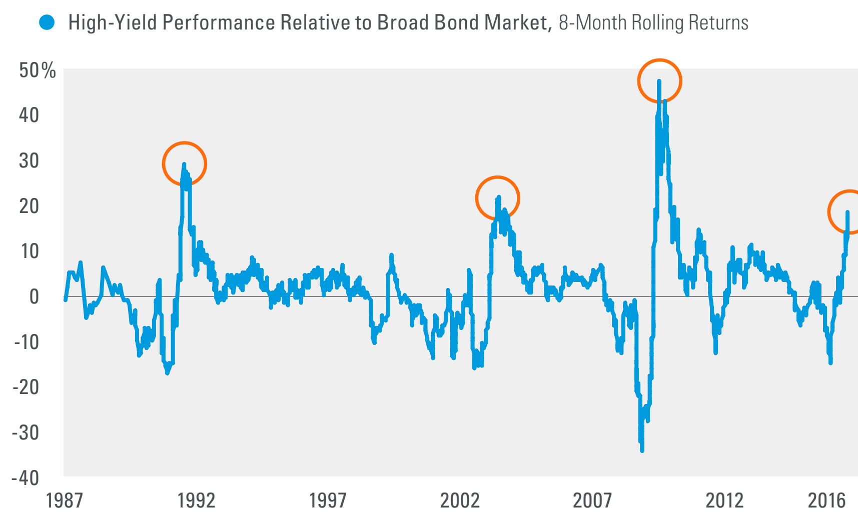
On balance, we remain cautiously optimistic, but we expect future performance to be driven more by yield than capital appreciation.

The high-yield market has continued to steam forward, with a positive return in 29 out of 35 weeks since bottoming on February 11, 2016. The impressive streak of performance has left little room for error in the market, however. In some respects, fundamentals are improving, evidenced by reduced default forecasts for the coming year. We believe any further decline in default rates may be already priced into the market, leaving valuations still on the expensive side of fair value. In other fundamental areas, like nonfinancial corporate leverage (i.e., the amount of debt a company has relative to its earnings), the trend is less encouraging.

OUTPERFORMANCE REMAINS HISTORIC

Just over eight months ago on February 11, 2016, the price of oil bottomed out at $26 and with it, the high-yield market found a bottom as well. With oil at its lowest price since late 2003, concerns over energy-related defaults sent high-yield spreads over comparable Treasuries skyrocketing. With oil recently holding near $50 ($50.02 as of October 17, 2016), the recovery in high-yield since mid-

1 MAGNITUDE OF HIGH-YIELD'S OUTPERFORMANCE VS. BROAD BOND MARKET HAS OCCURRED JUST 4 TIMES IN 30 YEARS



Source: LPL Research, Bloomberg 10/13/16

Chart represents total return advantage of Barclays US High Yield Index over the Barclays US Aggregate Index over rolling 8-month periods.

Past performance is not an indication of future results.

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February has been historic. High-yield outperformed the broad bond market by 19.1% from February 11, 2016 to October 11, 2016, only the fourth time in the last 30 years that outperformance of this magnitude has occurred over an eight-month period [Figure 1].*

LED BY HIGH-YIELD ENERGY, FOR BETTER OR WORSE

High-yield energy debt comprised 16.0% of the high-yield market in the third quarter of 2014, before falling to a low of 10.7% to end 2015 due to defaults and the declining price of the sub-index. That percentage has increased to 13.6% to end the third quarter of 2016, as high-yield energy has recovered from its weakest levels and as the debt of some investment-grade energy firms has been downgraded into the high-yield universe. The continued recovery since mid-February 2016 has been led by the sector that originally brought about the weakness: high-yield energy. High-yield energy's spread over comparable Treasuries decreased from a high of 17.8% on February 11, 2016 to 5.6% as of October 13, 2016 (based on the Barclays US High Yield Index). That spread compression is reflected in the performance of high-yield energy as well, which has outperformed high-yield by a large amount since mid-February 2016. High-yield energy returned 63.1% from February 11 through October 11, while high-yield overall returned 22.0%.

Although the rally in high-yield energy has driven overall high-yield strength since mid-February, it can also remind investors that the market may be susceptible to energy-related pullbacks, should the price of oil decline again. Although the high-yield market shrugged off oil weakness in August and September 2016, it may still be driven by oil [Figure 2]. A single variable being such a powerful potential driver of returns creates an added risk for high-yield investors.

*High-yield is represented by the Barclays US High Yield Index (22.0% return from 2/11/16 – 10/11/16) and the broad bond market is represented by the Barclays US Aggregate Index (2.8% return from 2/11/16 – 10/11/16).

2 DESPITE DISLOCATING IN AUGUST AND SEPTEMBER, OIL REMAINS A POWERFUL FORCE IN HIGH-YIELD

Source: LPL Research, Bloomberg 10/13/16

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. High-yield spread is the yield differential between the average yield of high-yield bonds and the average yield of comparable maturity Treasury bonds.

Performance is historical and no guarantee of future results.

DEFAULTS FORECAST TO SLOW…

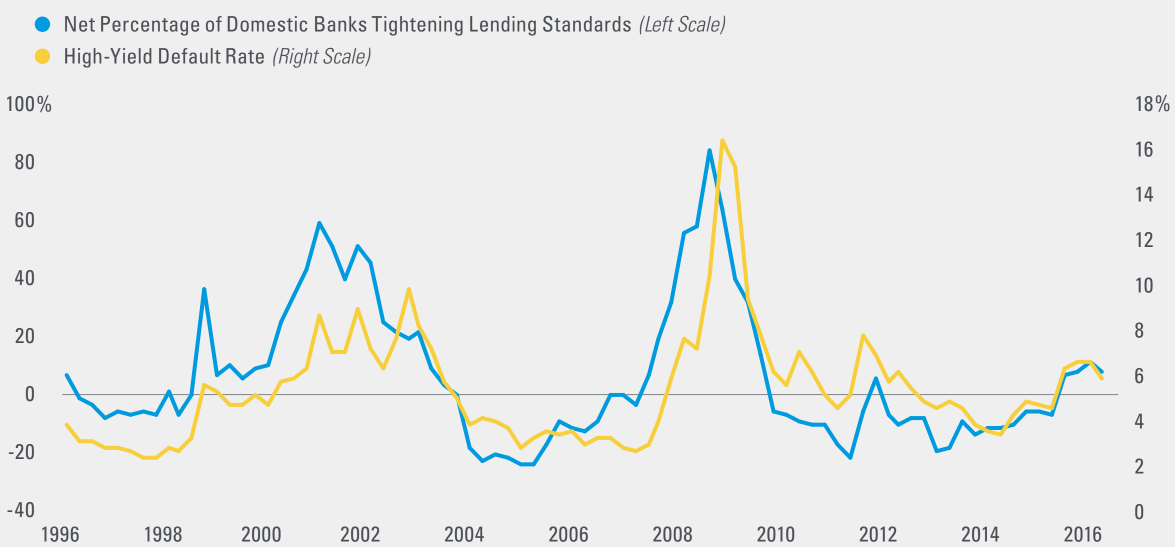
Rating agencies are forecasting lower high-yield defaults for the year ahead, a positive sign for the market. After ending the third quarter of 2016 with a 4.5% default rate, Moody's forecasts a 4.4% default rate to end 2016 and a 3.3% default rate at the end of the third quarter 2017. Fitch, similarly, is forecasting a 3% default rate for high-yield in 2017. High-yield downgrade-to-upgrade ratios have also declined significantly in the third quarter from elevated levels seen in early 2016 and late 2015.

Another useful leading indicator of defaults, historically, has been the Federal Reserve (Fed) Senior Loan Officer Survey, which shows the net percentage of banks that are tightening lending standards for medium and large companies. As banks become skittish about credit quality concerns, they tighten lending standards. Logically, firms that can't get loans are much more likely to default. Banks have been tightening lending standards since late 2015; however, that tightening decelerated in the survey's most recent reading on August 1, 2016 [Figure 3]. A further deceleration of tightening in the next reading (scheduled for early November) would be additional confirmation of an improving lending environment and a positive confirmation for high-yield's relatively expensive valuations.

…BUT THE GOOD NEWS IS LARGELY PRICED IN

Markets are forward-looking, and despite the positive sign of slowing defaults, high-yield valuations appear to already reflect that reality. In our view, a current yield spread of near 4.6% represents an expensive high-yield market, and one that is pricing in a significant decline in the rate of defaults ahead. Measuring how much current yield spreads compensate investors for expected risks can help quantify fair value. High-yield spreads compensate investors not only for default risks but for liquidity and other risks that can be termed the "excess spread." Looking back at market performance over default cycles to obtain

3 FEDERAL RESERVE SENIOR LOAN OFFICER SURVEY MAY POINT TO LOWER DEFAULTS AHEAD



Source: LPL Research, Bloomberg, Federal Reserve, Moody's 10/13/16

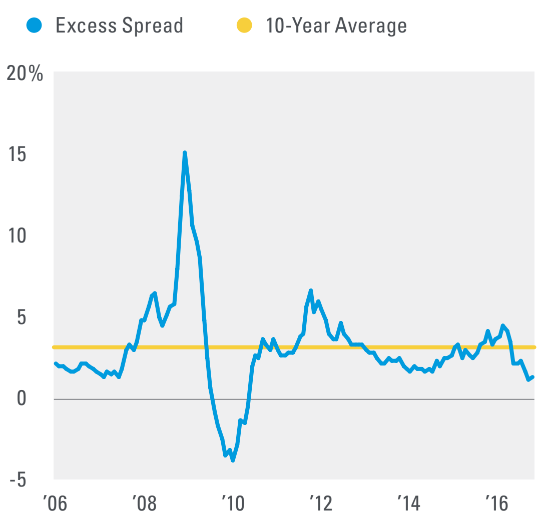
Past performance is not an indication of future results.

the historical excess spread and comparing that to today's level can indicate how over- or undervalued the market may be. As of the end of the third quarter 2016, the high-yield market's excess spread was considerably below its historical average, indicating pricey valuations and a market pricing in a significant decrease in defaults [Figure 4].

SOME LESS ENCOURAGING SIGNS

Nonfinancial corporate leverage can indicate how much debt firms in the high-yield market are carrying on a relative basis. Leverage has been increasing, with the Fed taking notice, as the Fed's September meeting minutes indicate: "A few participants expressed concern that the protracted period of very low interest rates might be encouraging excessive borrowing and increased leverage in the nonfinancial corporate sector." For high-yield companies, the median ratio of debt to EBITDA (earnings before interest, taxes, depreciation, and amortization) is now 5.0 times. For comparison purposes, that level stood at 4.2 times in 2008. This development has given markets and the Fed pause, and is something we will monitor.

4 EXCESS SPREAD BELOW HISTORICAL AVERAGE INDICATES DECREASE IN DEFAULTS IS PRICED IN



Source: LPL Research, Bloomberg 10/13/16

Excess spread calculation assumes a 20% recovery on defaulted assets.

Past performance is not an indication of future results.

CONCLUSION

While the continued strength in high-yield over the last months has reduced opportunities for future improvement in valuations, the market may continue to tighten as investors reach for yield globally. Conversely, equity market weakness or oil price weakness may drive spreads wider and lead to underperformance relative to other segments of the bond market. Although fundamental indicators are mixed and performance this year has already been impressive, there is still optimism for further improvement. That optimism, however, is largely priced into the high-yield market, leaving us cautiously optimistic on the sector as a whole. Despite the risks, we think high-yield can still add value as a small complement to high-quality fixed income for suitable investors, as yield can be a powerful driver of return in a coupon-clipping environment. ■

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 indexes are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

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.

High-yield/junk bonds are not investment-grade securities, involve substantial risks, and generally should be part of the diversified portfolio of sophisticated investors.

Commodity-linked investments may be more volatile and less liquid than the underlying instruments or measures, and their value may be affected by the performance of the overall commodities baskets as well as weather, geopolitical events, and regulatory developments.

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.

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.

Moody's is an independent, unaffiliated research company that rates fixed income securities. Moody's assigns ratings on the basis of risk and the borrower's ability to make interest payments.

Leverage is the degree to which a company uses fixed-income securities such as debt and preferred equity. The more debt financing a company uses, the higher its financial leverage.

INDEX DESCRIPTIONS

The Barclays U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate and hybrid ARM pass-throughs), ABS, and CMBS (agency and non-agency).

The Barclays High Yield Bond 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 nonconvertible. Bonds issued by countries designated as emerging markets are excluded.

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