LPL RESEARCH

BOND MARKET PERSPECTIVES

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CLASSIC DRIVERS OF BOND YIELDS PUSH HIGHER

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KEY TAKEAWAYS

Better economic growth and higher inflation expectations are driving confidence in the trajectory of the global economy.

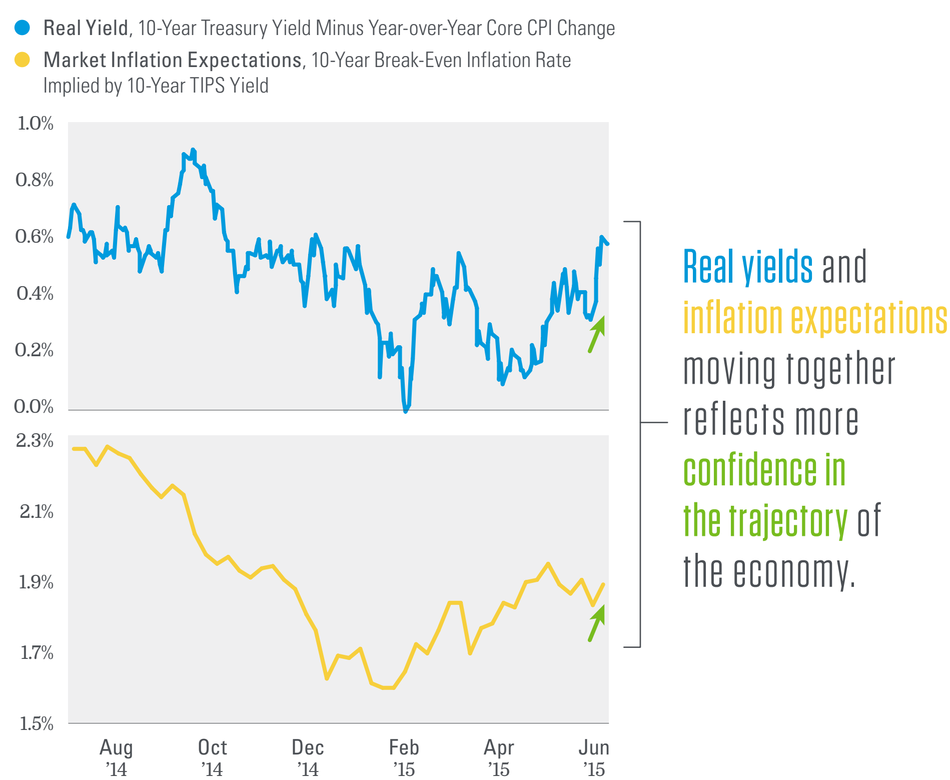
Lower yields and lingering price pressures still point to a very low-return environment for high-quality bonds in 2015.

The combination of corporate and Treasury supply may keep headwinds on bond investors.

Bond markets continue to price in more economic growth and higher inflation as the bond sell-off resumed last week, pushing 10- and 30-year Treasury yields to new year-to-date highs. High-quality bond returns, as measured by the broad Barclays Aggregate Bond Index, are now in negative territory year to date (-0.23%) following renewed weakness. Better U.S. economic data, coupled with comments from European Central Bank (ECB) President Mario Draghi that some bond volatility is to be expected, led to the poor tone.

Economic growth and inflation are classic drivers of bond yields, and increases in both were evident in bond markets. The inflation-adjusted, or real, 10-year Treasury reflects changes to economic growth expectations, while higher inflation expectations were also evident [Figure 1]. These two components do not always move together and usually growth or inflation expectations

1 BOTH ECONOMIC GROWTH EXPECTATIONS AND HIGHER INFLATION EXPECTATIONS PUSHED YIELDS SHARPLY HIGHER

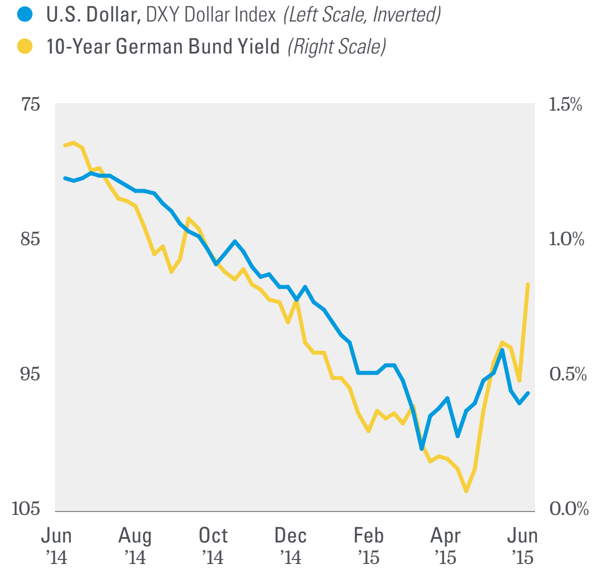


Source: LPL Research, Bloomberg 06/08/15 alternate as yield drivers. Real yields and inflation expectations moving together reflects more confidence in the trajectory of the economy.

> Even after last week's increase, both real yields and inflation expectations remain low relative to long-term history.

Even after last week's increase, both real yields and inflation expectations remain low relative to long-term history. Over the past 10 years the real yield on the 10-year Treasury averaged 1.3% while inflation expectations, as measured by 10-year Treasury Inflation-Protected Securities (TIPS), averaged 2.2%. Both measures remain subdued relative to history and reflect a still expensive bond market.

2 **GROWTH EXPECTATIONS EMBEDDED IN BOND YIELDS ALSO IMPACT CURRENCIES**



Source: LPL Research, Bloomberg 06/08/15

A CONNECTED WORLD

Improving and changing growth and inflation expectations also impact currencies. The improvement in European economic growth early in 2015, which picked up steam in April, contrasted to the weaker domestic economic results and helped put a stop to U.S. dollar strength in the first quarter of 2015. As European growth expectations improved, the euro began to appreciate versus the U.S. dollar. German yields, which reflect better European economic prospects, therefore remain correlated to changes in the U.S. dollar [Figure 2], as higher German yields reflect a weaker dollar and vice versa.

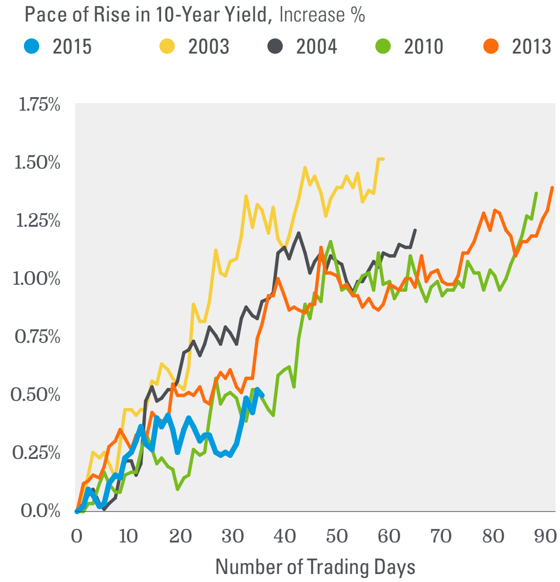
Domestic bond market weakness that began in April 2015 followed a pullback in Europe, led by German bunds. Since April 20, 2015, European government bonds, led by Germany, have underperformed their U.S. counterparts.* The 10-year German bund yield has increased by 0.8% versus a 0.5% increase in the 10-year Treasury yield from April 20, 2015, through June 8, 2015. The yield advantage of the 10-year Treasury versus the 10-year German Bund has narrowed from an all-time historic wide level of 1.9%, in March 2015, back down to 1.5%.

PULLBACK PERSPECTIVE

Compared with the most severe bond market pullbacks of the past 12 years, the current sell-off is more restrained but ranks similar to the 2010 QE2-inspired sell-off [Figure 3]. Prices declined quickly to start, but the lingering tug-of-war on bond prices led to stability in late May before last week's strong jobs report. In our view, the pace of weakness is likely to be more moderate compared with prior sell-offs, due to the fact the Fed is likely to take a very gradual approach to raising interest rates and inflation is similarly likely to increase

* As measured by the Citigroup World Government Bond Index (hedged) versus the Barclays Aggregate Bond Index from April 20, 2015 through June 8, 2015.

3 **COMPARING 2015 WITH PRIOR BOND MARKET SELL-OFFS**



Source: LPL Research, Bloomberg 06/08/15

gradually. We therefore find it unlikely that the current sell-off reaches the magnitude of prior sell-offs; but nonetheless, the lower level of yields combined with lingering price pressures still augurs for a very low-return environment for high-quality bonds in 2015.

The current week of June 8, 2015, presents additional challenges to bond investors in terms of supply. Bond market sentiment remains fragile and must now contend with additional supply in the form of 3-, 10-, and 30-year Treasury auctions. Demand for the new Treasuries may indicate whether the recent rise in yields has gone far enough to help stabilize bonds. In addition to Treasury supply, investment-grade corporate bond issuance remains elevated and on a record pace. The combination of corporate and Treasury supply may keep headwinds on bond investors. ■

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.

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.

Investing in foreign fixed income securities involves special additional risks. These risks include, but are not limited to, currency risk, political risk, and risk associated with foreign market settlement. Investing in emerging markets may accentuate these risks.

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

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 (CPI)—while providing a real rate of return guaranteed by the U.S. government. However, a few things you need to be aware of is that the CPI might not accurately match the general inflation rate; so the principal balance on TIPS may not keep pace with the actual rate of inflation. The real interest yields on TIPS may rise, especially if there is a sharp spike in interest rates. If so, the rate of return on TIPS could lag behind other types of inflation-protected securities, like floating rate notes and T-bills. TIPs do not pay the inflation-adjusted balance until maturity, and the accrued principal on TIPS could decline, if there is deflation.

Currency risk is a form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged."\

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 Citi World Government Bond Index (WGBI) measures the performance of fixed-rate, local currency, investment-grade sovereign bonds. The WGBI is a widely used benchmark that currently comprises sovereign debt from over 20 countries, denominated in a variety of currencies, and has more than 25 years of history available. The WGBI provides a broad benchmark for the global sovereign fixed income market. Sub-indexes are available in any combination of currency, maturity, or rating.

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