LPL RESEARCH

BOND MARKET PERSPECTIVES

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AUGUST RECAP

Anthony Valeri, CFA *Fixed Income & Investment Strategist, LPL Financial*
Colin Allen, CFA *Senior Analyst, LPL Financial*

KEY TAKEAWAYS

Mixed messages from the Fed and middle of the road economic data kept Treasury yields in a very tight trading range throughout August.

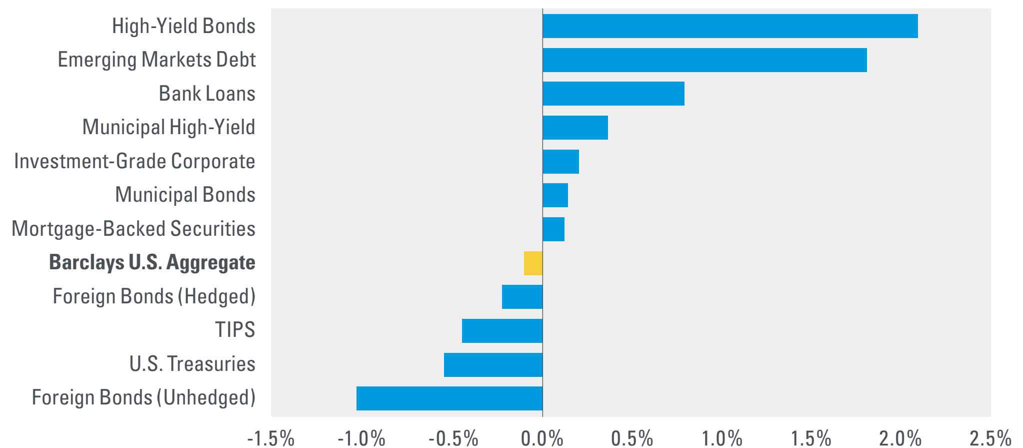
Economically sensitive sectors continued to rally in August, while high-quality bonds lagged as Treasury yields moved toward the upper end of their recent range.

The employment report from September 2, 2016, may not have been strong enough to force a Fed rate hike in September, but was solid enough to bolster the case for a December hike.

August proved to be a challenging month for high-quality fixed income [Figure 1]. Treasury yields rose across the maturity spectrum, with the benchmark 10-year yield ending the month at 1.58%, toward the high end of its recent range. The rising rate backdrop was a headwind for high-quality bonds, with both Treasuries (-0.6% as measured by the Barclays U.S. Treasury Index), and the Barclays Aggregate (-0.1%) seeing negative returns for the month. Municipals bucked the high-quality performance trend, but managed a positive return of just 0.1%.

Economically sensitive, lower credit-quality bonds continued the rally begun in mid-February 2016, as global investors continued to search for yield in a low-yielding environment. The rebound in the price of oil, up 7.5% during August, was an additional tailwind for high-yield and emerging markets debt (EMD),

1 ECONOMICALLY SENSITIVE SECTORS WERE STANDOUT PERFORMERS IN AUGUST



Source: LPL Research, FactSet 09/01/16

Indexes referenced are Barclays U.S. High Yield Index, JPMorgan EMBI Global Index, Barclays U.S. High Yield Loan Index, Barclays Corporate Index, Barclays U.S. Aggregate Securitized MBS, Barclays Municipal Bond Index, Barclays U.S. Aggregate Bond Index, Citigroup World Government Bond Index Hedged, Barclays U.S. Treasury Inflation Protected Notes Index, Citigroup World Government Bond Index Unhedged, Barclays US Aggregate Government Treasury Index.

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which were notably strong during the month. High-yield returned 2.1% during August, bringing its year-to-date return to 14.4%. High-yield's performance since mid-February continues to be extreme, with a rolling six-month outperformance relative to the Barclays Aggregate at an impressive 12%, the highest over any such rolling six-month period in the last 10 years, outside of the recovery from the Great Recession.

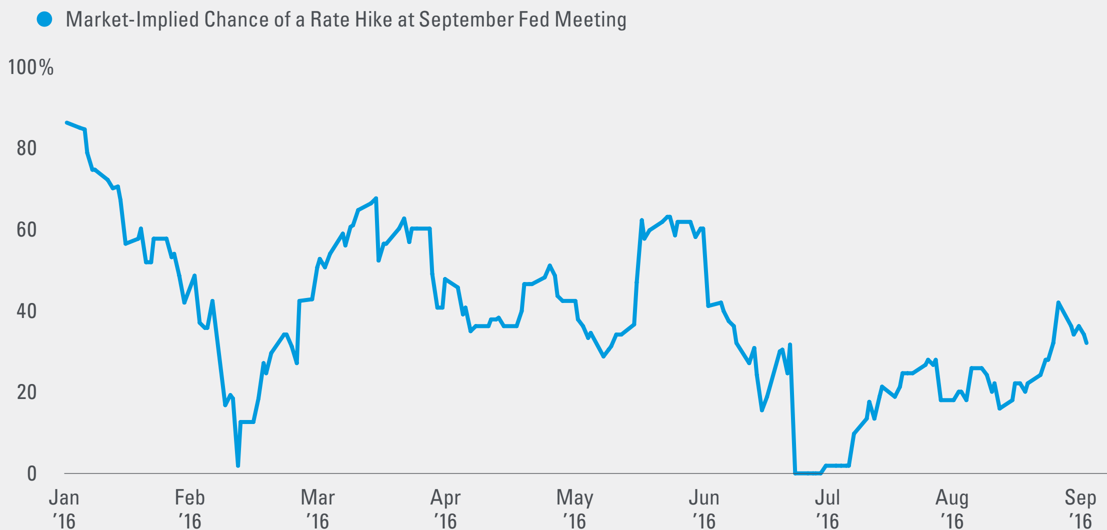
The rise in yields was also a tailwind for preferreds, as financial stocks were beneficiaries of higher interest rates. The rise in Libor (London interbank offered rate), covered in last week's *Bond Market Perspectives*, was a benefit for bank loans, which returned 0.8% during August.

RATE HIKE TIMETABLE

A look at the market-implied chances of another rate hike occurring by September 2016, which have oscillated between 0% and over 60% in recent months, shows just how volatile short-term rate hike expectations can be [Figure 2]. The opinions of market participants fluctuate with Federal Reserve (Fed) statements, global events, and economic data points.

Fed Chair Janet Yellen's August speech in Jackson Hole, where she indicated that the case for a rate hike had improved, served to push Treasury yields higher. Fed Vice Chair Fischer piled on soon thereafter, saying that Yellen's speech could be consistent with two rate hikes in 2016. Yields rose

2 THE MARKET-IMPLIED CHANCES OF A SEPTEMBER RATE HIKE HAVE FLUCTUATED WILDLY



Source: LPL Research, Bloomberg 09/01/16

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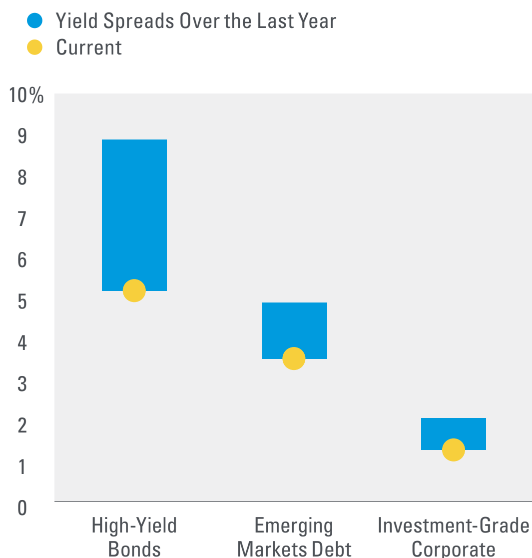
in response to these hawkish comments, but have since receded. The middle of the road employment report for August (released on September 2) may have been weak enough to prevent the Fed from moving in September, while being solid enough to bolster the case for a December 2016 hike.

Regardless of whether the next rate hike occurs in September or December, the market and the Fed agree that the increase in the Fed's policy rate will be slow and steady. Looking beyond 2016, however, is where markets are still drastically underpricing the Fed's stated course. The Fed's median projection for the long-term (approximately five years) fed funds rate is 3%, but the market is currently pricing in a mere 1.65%.

3 SPREADS OVER COMPARABLE TREASURIES ARE AT THEIR TIGHTEST LEVELS OF THE LAST YEAR



Source: LPL Research, Bloomberg 09/02/16

Indexes referenced are Barclays U.S. High Yield Index, JPMorgan EMBI Global Index, and the Barclays Corporate Index.

VALUE REMAINS ELUSIVE

Another strong rally in lower-quality bonds has resulted in richer valuations across the fixed income market, making value difficult to find [Figure 3].

We still believe in fixed income for its diversification benefits as a risk mitigation tool, but no fixed income sector stands out as overly attractive. We continue to view investment-grade corporates as potentially delivering incremental value over Treasuries, and think mortgage-backed securities (MBS) may add value as a high-quality option against a backdrop of range-bound yields. Although we believe high-yield may be slightly overvalued at this point, given its tremendous strength year to date, we still think a small allocation can add value for suitable investors, given its substantial yield. We prefer municipals over Treasuries, as a favorable supply/demand imbalance should remain a tailwind, with state and municipal spending still restrained, and the market's appetite for yield remaining insatiable. ■

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.

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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.

Investing in foreign and emerging markets debt securities involves special additional risks. These risks include, but are not limited to, currency risk, geopolitical and regulatory risk, and risk associated with varying settlement standards.

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

Mortgage-backed securities are subject to credit, default, 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, market and interest rate risk.

Municipal bonds are subject to availability, price, and to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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.

Preferred stock investing involves risk, which may include loss of principal, and are subject to many of the same risks which affect fixed income securities

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.

INDEX DESCRIPTIONS

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.

The Barclays U.S. High Yield Loan Index tracks the market for dollar-denominated floating-rate leveraged loans. Instead of individual securities, the U.S. High-Yield Loan Index is composed of loan tranches that may contain multiple contracts at the borrower level.

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 U.S. Corporate Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate, taxable corporate bond market.

The Barclays U.S. Treasury Index is an unmanaged index of public debt obligations of the U.S. Treasury with a remaining maturity of one year or more. The index does not include T-bills (due to the maturity constraint), zero coupon bonds (strips), or Treasury Inflation-Protected Securities (TIPS).

The Barclays U.S. Mortgage Backed Securities (MBS) Index tracks agency mortgage backed pass-through securities (both fixed rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

The Barclays U.S. Treasury TIPS Index is a rules-based, market value-weighted index that tracks inflation-protected securities issued by the U.S. Treasury.

The JP Morgan Emerging Markets Bond Index is a benchmark index for measuring the total return performance of international government bonds issued by emerging markets countries that are considered sovereign (issued in something other than local currency) and that meet specific liquidity and structural requirements.

The Barlcays U.S. Municipal Index covers the USD-denominated, long-term, tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds.

The Citigroup Non-U.S. World Government Bond Hedged Index measures the performance of fixed-rate, local currency, investment grade sovereign bonds. This index 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. It provides a broad benchmark for the global sovereign fixed income market, excluding the U.S., with currencies hedged against the U.S. dollar.

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